

INFLATION INDEXING IN BERKELEY
RENT REGULATION IN THE AFTERMATH
OF THE SEARLE DECISION

HR & A

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Los Angeles • Denver • New York



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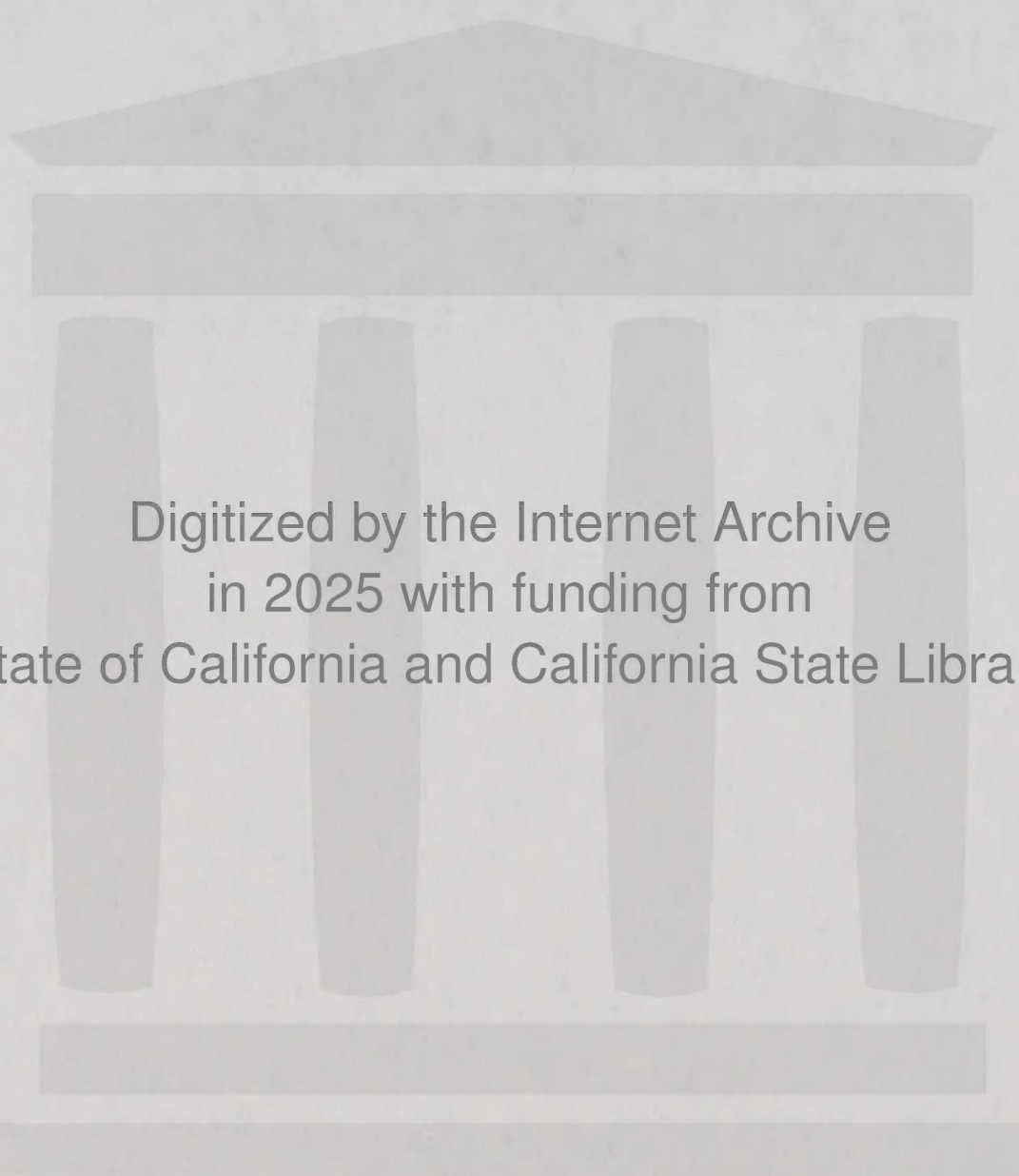
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I. Introduction

In its recent decision in Searle et al. v. the City of Berkeley Rent Stabilization Board et al., the California Court of Appeal held that:

[the Board's] rent control regulations violate due process when they (1) provide an inflation adjustment of net income by an arbitrary percentage of the increase in the consumer price index, (2) prescribe an inflation adjustment of net income only from the middle of the year after net income was frozen to the month before a landlord applies for the adjustment, (3) require each landlord to file and pursue an individual application in order to obtain the uniform inflation adjustment, and (4) fail to establish guidelines as to what constitutes a fair return on investment so that landlords may make informed decisions whether to petition for an increase in rents on the basis that they do not receive a fair return on their investment.¹

Following this decision, the Berkeley Rent Stabilization Board (BRSB) retained Hamilton, Rabinovitz and Alschuler, Inc. (HR&A) to assist it in conforming the Board's Regulations to the first and fourth findings of the Court's opinion. This report documents HR&A's analysis of the issues related to the Court's first finding, concerning the indexing of net operating income (NOI)² by a percentage of the consumer price index (CPI). A second report containing HR&A's analysis of the issues related to the Court's fourth finding, concerning fair return regulations, will be issued at a later date.

¹Searle. et al. v. Berkeley Rent Stabilization Board. et al., p. 1. Hereinafter, Searle.

²In standard parlance used in the real estate industry, the net operating income (NOI) realized by a rental property is defined as effective gross income (which consists of actual rental receipts and other property-related income (e.g., parking space fees)) minus operating expenses (which specifically exclude the cost of debt service and such non-cash costs as depreciation).

The report first briefly reviews the essence of the Searle decision as it pertains to the issue of indexing. The next section then summarizes the provisions made for inflation indexing in the 14 California municipalities with rent control ordinances that are currently in force, and in selected non-California jurisdictions which provide a sampling of the types of approaches to these issues which are utilized elsewhere in the nation. Then follows a section which reviews and analyzes the specific questions which the consultants were asked to address. The fifth section describes the minimum changes in the BRSB Regulations necessary to bring them into conformance with the Searle decision. The final section presents the consultants' recommendations.¹

¹HR&A is a consulting firm, not a law firm, and does not purport to offer professional legal opinions or assessments. This and all other statements herein with respect to legal interpretation and/or the legal adequacy or other characteristics of the steps recommended or discussed are subject to confirmation or correction by such legal authorities as the Board may cause to review them.

II. The Courts and Indexing For Inflation

In Searle the Court found no rational basis for the formula contained in BRSB Regulation 1264 that provides for the indexing of NOI at 40% of the change in the CPI.¹ In its discussion of the timing provisions contained in this Regulation, the Court concluded that:

It is, after all, the purpose of Regulation 1264 to allow landlords to recoup the purchasing power of their NOI lost because of inflation. The higher the inflation rate, the greater the loss, absent indexing.²

Furthermore in citing the decision in the 1984 Fisher case³, the Court noted that:

...the Supreme Court, while upholding the facial validity of Berkeley's rent control ordinance, observed that continued failure to adjust base year NOI for inflation would eventually produce confiscatory results.⁴

Finally, the Searle Court reiterated its position, originally established in the earlier Cotati case, that:

The purpose of rent control is to permit an efficient landlord to pay all actual and reasonable expenses and receive a fair profit while, at the same time, protecting the public interest in having affordable and properly maintained housing available to the citizens of the community.⁵

These statements inform both the analysis of NOI indexing and the recommendations which follow.

¹Ibid., p. 7.

²Ibid., p. 9.

³Fisher v. City of Berkeley, 37 Cal.3d 644; 209 Cal. Rptr. 682, 693 P.2d 261 [Dec. 1984].

⁴Searle, at p. 7 and p. 17.

⁵Cotati Alliance for Better Housing v. City of Cotati, 148 Cal.App.3d 280, 296 (1983).

III. Comparative Review Of Rent Control Ordinances

In order to understand the approaches that have been adopted by municipalities to regulate residential rents, and in particular the methods used to adjust NOI by such regulations, HR&A collected and reviewed the ordinances and regulations of all 14 municipalities in California with rent regulation regimes, together with those of seven selected jurisdictions of various sizes in other areas of the country.¹ The comparative review focused on four specific characteristics that pertain to the Searle decision: 1) the definition of NOI, if any, contained in the ordinance or regulations; 2) the inflation index (e.g., CPI), if any, that is used to make annual adjustments to rents or NOI; 3) any adjustment mechanisms and arithmetic formulas applied to the chosen index in order to make annual adjustments; 4) any provisions that allow for the decontrol of rents when a tenant vacates a unit.

The following summary presentations of the results of this review provide BRSB with a decision backdrop comprised of actual examples of the approaches to the indexing issue raised in Searle which have been adopted by other jurisdictions inside and outside

¹HR&A did not collect documents associated with the rent control ordinance adopted by the City of San Anselmo, California because that City only regulates rents charged for "second units" that are specifically intended for low-income households. Such second units can only be constructed in specific areas of San Anselmo on lots which already contain an owner occupied housing unit, and no more than one second unit can be constructed per lot. These restrictions make the San Anselmo rent control regime non-comparable to the more general regimes represented by the comparison jurisdictions included herein. The review also omitted the 51 California regulation regimes governing mobile homes, which are not covered in the Berkeley Ordinance and, according to the 1990 census, account for only 14 units in the City, comprising only one-tenth of one percent of the Berkeley housing stock. Commercial rent control ordinances were also excluded from this review.

California. In reviewing it, the reader needs to keep clearly in mind the difference between adjusting rents, on the one hand, and adjusting the landlord's net operating income, on the other. The two are related in that any adjustment of rent must have some effect on the landlord's NOI. But, as will be seen below, many jurisdictions index rents without reference to the net income impact on landlords, while Berkeley and some other jurisdictions make most of their indexing adjustments sensitive to the landlord's net income or operating costs.

It follows that it is just as important from a policy standpoint to be clear about what is being indexed for inflation -- rents or NOI -- as it is to be clear about what price index is being fully or partially employed to achieve the indexing.

1. California Jurisdictions

When the 14 California ordinances regulating residential rents are compared along the four dimensions described above, it becomes apparent that the approaches to residential rent regulation in California fall into two distinct groups. This is demonstrated in Table I on the following page.

As the Table shows, the first group consists of seven communities that include a definition of NOI in their rent regulation ordinances or regulations, and specify one or more mechanisms to adjust rents in ways that are sensitive to the landlord's operating costs or NOI. With two exceptions, one of which is partial, none of these seven cities allow the decontrol of rents when tenants vacate their units voluntarily.¹

¹The clear exception is Los Angeles, which permits full decontrol upon vacancy. The partial exception is the West Hollywood Ordinance which does allow for partial decontrol of rents if a tenant vacates the unit voluntarily. However, the permitted rent increase is limited to 10% over the rent paid by the vacating tenant, and such an adjustment can only be made once in every five years.

Table I
SELECTED CHARACTERISTICS OF RENT CONTROL ORDINANCES IN
CALIFORNIA AND MAJOR JURISDICTIONS IN OTHER STATES

	Index Used For Annual General Rent Adjustments	Annual Rent Adjustment Mechanism ^j	NOI Defined In The Ordinance Or Regulations ^k	Vacancy Decontrol
CALIFORNIA JURISDICTIONS				
Berkeley	Operating cost analysis/legislated	100% of operating expenses	Yes in IRA – 40% CPI	No
Santa Monica	Actual operating costs/CPI-U	100% of operating expenses & NOI at 40% * CPI	Yes in AGA & IRA – 40% CPI	No
Cotati	Actual operating costs/CPI-U	100% of operating expenses & NOI at 100% * CPI	Yes in AGA & IRA – 55% CPI in IRA	No
E. Palo Alto	CPI-U or residential rent component	Lower of 100% * CPI or residential rent component	Yes in IRA – 100% of lower index	No
Palm Springs	CPI-U	75% * CPI	Yes in IRA – 50% CPI	No ^a
West Hollywood	CPI-U	75% * CPI to 7% max + .5% each for gas & electricity	Yes in IRA – 60% CPI	Partial ^b
Los Angeles	CPI-U	100% * CPI	Yes in IRA – 100% CPI	Yes
San Francisco	CPI-U	4% < 60% * CPI < 7%	No	Partial ^c
San Jose	None	8% flat rate	No	Yes
Los Gatos	CPI-U	70% * CPI or 5% whichever is greater	No	Yes
Thousand Oaks	CPI-U	3% < 75% * CPI < 7%	No	Yes
Beverly Hills	CPI-U	100% * CPI to 8%–10% max	No	Yes
Hayward	None	Legislated	No	Yes
Oakland	None	Legislated: 10% 80–83; 8% 83–86; 6% to date	No	Yes
JURISDICTIONS IN OTHER STATES				
Brookline, MA	Operating costs + other factors	Legislated – considers a variety of factors	Yes in AGA & IRA – legislated	Partial ^d
Cambridge, MA	Actual and indexed operating costs – CPI-U	100% of operating costs + 85% of NOI	Yes in AGA & IRA – 100% CPI	No
Boston, MA	CPI-U	100% of CPI	Yes in IRA – maintain nominal \$ NOI	Partial ^e
New York City – Controlled	Maximum base rent analysis	7.5% per year up to maximum base rent (MBR)	Yes arguably implied in MBR formula	Partial ^f
New York City – Stabilized	Operating costs + other factors	Legislated – considers a variety of factors	No	Partial ^d
Washington, D.C.	CPI-W	100% of CPI <= 10% maximum	No	Partial ^g
Jersey City, N.J.	CPI-U	100% of CPI or 4%, whichever is less	No	No ^h
Newark, N.J.	None	Legislated, 4% for bldgs. >49 units, 5% otherwise	No	Partial ⁱ

Sources: Rent control/stabilization ordinances and regulations of respective jurisdictions collected during May/June 1991.

Excludes ordinances controlling rents in mobil home parks and subsidized housing programs.

Notes: ^aNo, unless to preclude a confiscatory taking.

^bPartial; limited to 10% maximum rent increase once every 5 years.

^cUnits in buildings with 5 or fewer units decontrolled; units in buildings with 6+ units covered by rent stabilization.

^dPartial – vacant units may be allowed increases above annual general adjustment.

^ePartial – decontrolled rents capped after being set at market levels – allowed increases are set according to CPI and vary somewhat by type of tenant (low income, elderly)

^fPartial – all units in bldgs < 10 units; 80% in bldgs >= 10 units if 20% set-aside for low-moderate income households.

^gPartial – 12% of rent ceiling or rent for a "comparable unit."

^hNo – allowed only to amortize capital improvements.

ⁱPartial – maximum of 25% if improvements greater than \$99 made to vacant units.

^jCPI fully defined (i.e., CPI-U, CPI-W) in AGA column.

^kAllows for 10% minimum and 14% maximum rent adjustment upon voluntary vacancy.

The second group consists of seven communities which neither include a definition of NOI in their regulation regimes nor do they specify any relationship of NOI to rent regulation. These communities uniformly allow decontrol of rents when tenants vacate their units voluntarily. With one partial exception, these systems rely on unit turnover, and the resulting periodic marking up of some or all rents to market levels, to keep landlord NOI sufficient to maintain the incentive keep up the property.¹ In this type of a system, the task of the inflation indexing feature of the regulatory regime is simply to maintain all or most of the purchasing power of the rents received until the decontrol feature permits them to be marked to market.

Since both the Berkeley rent stabilization regime and the Searle decision are expressly concerned with the maintenance of NOI in the presence of inflation, the review that follows concentrates primarily on the six Cities in addition to Berkeley that have adopted rent control ordinances which contain a definition of NOI. However, a brief discussion of the indexes and mechanisms used to adjust rents in the second category of California municipalities is also included.

A. Ordinances With Provisions For NOI Adjustment

In reviewing the definitions of NOI employed in the seven California ordinances which do such definition, the study found that the Berkeley Ordinance is the only one of the seven which does not conform to the industry definition stated above. Berkeley's definition of NOI differs in that it does not permit deduction of vacancy or collection losses from scheduled rental receipts. To the extent that such losses have been sustained, therefore, the Berkeley definition will overstate effective gross

¹The partial exception is San Francisco, which recently modified its former provision for full vacancy decontrol to permit only partial decontrol.

income, as it is more customarily defined, and thereby overstate NOI by the same amount. It must be noted, however, that, while the other ordinances allow for some deduction of vacancy and collection losses, they limit such deductions to three to four percent of gross or scheduled rents, unless specified empirical evidence is presented to support losses above these legislated limits.¹

As to the procedure used by these jurisdictions to adjust NOI for the effects of inflation, the study found that two general approaches are employed.

The first approach adjusts NOI through annual general rent adjustments (AGAs) which allow for across-the-board rent increases by property owners without requiring formal hearings or petitions on a property-by-property basis. Cotati and Santa Monica allow for this adjustment of NOI through the AGA process. Their ordinances incorporate annual rent adjustments that attempt to reflect 100% of annual changes (increases and decreases) in operating costs, and also to adjust all or a percentage of NOI for changes in the cost of living. (It should also be observed in passing that, although they differ from Berkeley's on this issue of whether NOI is adjusted through the AGA process, the Santa Monica and Cotati ordinances seem to have the most in common with the Berkeley Ordinance conceptually, and, based on a comparison of the language found in each ordinance, all three appear to have been drafted from a common model law.)

The second approach, which is utilized by Berkeley and four other California municipalities, allows for inflation adjustment of NOI only through individual rent adjustments (IRAs). These adjustments must be individually requested by landlords through a

¹Santa Monica, Palm Springs, West Hollywood, and East Palo Alto all limit vacancy and collection losses to 3% of gross or scheduled rents without an empirical showing, while Cotati allows for losses of up to 4% of gross rents.

formal hearing process that is carried out on a property-by-property basis. In all of these municipalities except Berkeley, however, adjustments to NOI through IRA proceedings are made under the provisions of the relevant ordinance designed to assure a "fair return" to the landlord.¹ Only Berkeley provides for NOI adjustments designed to offset inflation that are authorized through IRA proceedings carried out under the Regulation aimed, as its title says, at "Maintenance of Net Operating Income."

In other words, all California jurisdictions other than Berkeley which define NOI treat the AGA process as the proper across-the-board vehicle for keeping either rents or landlord net operating income indexed for inflation to the extent that each jurisdiction wishes to do so. Four such cities -- East Palo Alto, Palm Springs, West Hollywood and Los Angeles -- prefer to use AGAs to index rents rather than NOI. Two others -- Santa Monica and Cotati -- apply AGAs to operating expenses and NOI. Berkeley, on the other hand, uses the AGA process only to permit the portion of regulated rents that is designed to defray landlord operating expenses to keep pace with the annual BRSB measure of changes in those expenses. Indexing of NOI itself can only be achieved in Berkeley through individual petition.

Moving from the procedure used to make inflation adjustments in NOI to the degree to which developments in a price index are translated into inflation adjustments, the study found that California cities differ noticeably in this respect. The summary below begins with the four cities which use the AGA process to index the rent charged for a unit, rather than seeking to reach through and directly index the landlord's operating expenses or net income from that unit. The discussion then proceeds to the

¹The NOI concept comes into play in Los Angeles only in connection with establishing a "just and reasonable return" to the landlord. See City of Los Angeles, Rent Adjustment Commission, Regulations and Guidelines, No. 240.00, which includes amendments through December 1990.

two cities that employ AGAs to index both operating expenses and NOI. Finally, it describes the current inflation indexing practice in Berkeley.

The East Palo Alto Ordinance uses AGAs to adjust maximum rents. It permits annual adjustments equal to the lower of the following two alternative figures: (a) 100% of the annual change in the CPI-All Items price index for urban consumers (generally known as the CPI-U); or (b) 100% of the annual change in just the residential rent component of the CPI-U index. Only if, having made the adjustment permitted by the AGA, the landlord sees fit to petition for an IRA does NOI come into play. If the landlord prevails, the same adjustment mechanism (i.e., the lower of the two above price indices) is used to adjust the rent to offset the effects of inflation on the landlord's NOI. East Palo Alto does not allow for vacancy decontrol rent adjustments.

Palm Springs also uses the CPI-U for AGAs applied to rents. But the general rent increase there is limited to 75% of the annual increase in the index. There is no additional adjustment for landlord-paid utilities. In the event of IRA proceedings, NOI becomes relevant. The Palm Springs Ordinance allows the successful petitioner landlord's NOI to be indexed at 50% of the change in the CPI-U over the period in question. Although this Ordinance does not allow for general vacancy decontrol, an amendment adopted in February 1989 allows the Palm Springs Commission to grant such vacancy increases if they are required by the decisions of Federal or State appellate courts in order to avoid a confiscatory taking.¹

West Hollywood follows a somewhat similar policy, using the CPI-U to index the AGAs applied to rents and limiting general rent increases to 75% of the annual increase in that index. However, West Hollywood imposes a ceiling on rent increases of 7%

¹Palm Springs Municipal Code, Section 4.08.060 (i).

in any one year. However, an additional one half of one percent per service is allowed for gas and electric services paid by the landlord, so that a landlord who pays for both may impose an increase of up to 8% if the CPI-U rises enough to support it. If the AGA adjustment is followed by a petition for an IRA, the West Hollywood Ordinance allows the NOI of a successful landlord petitioner to be indexed at 60% of the change in the CPI-U over the period in question. As noted earlier, vacancy decontrol partially exists in West Hollywood, but is limited to one rent adjustment of not more than 10% in every five years.

Los Angeles indexes rents to 100% of the regional CPI-U, but it imposes both a ceiling and a floor on the increases which can result in any one year. The ceiling is 8%, while the floor is 3%. Direct adjustment of NOI does not come into play unless the landlord chooses to file a petition seeking a "just and reasonable return" (an IRA by another name). If the petition is successful, the landlord can be granted indexing of NOI at 100% of the CPI-U. Unlike West Hollywood, Los Angeles permits full decontrol of the rent when a unit becomes vacant.

The two cities which use the AGA and IRA processes to index operating expenses and NOI, rather than rents, are Santa Monica and Cotati. Since June 1988, Santa Monica has used the AGA process not only to index operating expenses according to a local study of actual developments in those expenses, but also to index average landlord NOI by 40% of the change in the CPI-U.¹ The 40% share has been justified on the basis of 1978 apartment revenue and expense data which were held to show that, on average, 60% of NOI was required to defray debt service costs. Variable rate mortgages were either rare or nonexistent in 1978. Consequently,

¹Adjusting NOI for 40% of the annual change in the CPI-U was originally part of Santa Monica Regulation 4106 which specifies allowable rent increases under IRA petitions. It was subsequently incorporated in that City's AGA process.

debt service was considered a fixed expense not subject to inflation. Therefore, Santa Monica elected to exclude 60% of NOI from the AGA adjustments designed to account for the effects on NOI of changes in the cost of living. In the event of an IRA petition, the same 40% share of the annual change in the CPI-U is employed as the adjustment available for individual landlords who can show that the AGA did not achieve that result in their own cases.

However, recent documents indicate that the staff of the Santa Monica Rent Control Board has now concluded that this approach, in the presence of inflation, necessarily reduces the real value of NOI from that in any given base year.¹ Similarly, the staff of the Board now recognizes that indexing a portion of NOI necessarily reduces over time the percentage share of rents realized as NOI to the owner, while simultaneously increasing the percentage share of rents required to cover operating expenses and debt service.² It may also be observed that since there is no mechanism in the Santa Monica Ordinance that can cause real NOI to keep pace with changes in the cost of living, the real value of rent controlled properties there is likely to fall as inflation increases, so that property maintenance spending by landlords may also be reduced.

(It may also be deemed relevant that, in response to landlord withdrawal of approximately 1,200 rental units from the market, as allowed by the Ellis Act, the Santa Monica Rent Control Board is reportedly considering a rent adjustment program for units with a history of what are usually termed "historically low

¹See the memorandum entitled "Supplemental Staff Report - Annual General Adjustment 1990/91 -- NOI Component" from Staff to the Santa Monica Rent Control Board, June 18, 1990, p. 1.

²See the memorandum entitled "Annual General Adjustment 1990/91" from Staff to the Santa Monica Rent Control Board, May 31, 1990, p. 8.

rents."¹ In the case of voluntary tenant vacating of units with such rents, the program under discussion would allow adjustment of base year rent to what Santa Monica defines as "market levels." Market level rents are defined as the median base rent at the time the Santa Monica Ordinance was adopted in 1979, refined according to the number of bedrooms in the unit and its location in one of the seven geographic areas of the City. According to Rent Board staff, about one-half of the 25,000 stabilized units in the City could qualify for a rent increase under this program.)

The City of Cotati also permitted only a percentage share of the CPI to be used to adjust NOI for inflation until the decision in the aforementioned Cotati case by the California Court of Appeal.² The Cotati Court's decision specified that: "If the net operating profit of a landlord continues to be the identical number of dollars, there is in time a real diminution to the landlord that eventually becomes confiscatory."³

In response, in 1985 Cotati revised its General Adjustment Regulation to:

...provide for rent increases which are adequate to cover residential rental property operating cost increases and to permit net operating income to increase at 100% of the rate of increase in the CPI (Consumer Price index-all items for all urban consumers, San Francisco-Oakland).⁴

¹Santa Monica Evening Outlook, July 24, 1991, pages A10 and A14. "Historically low rents," in the special parlance that has grown up around rent stabilization issues, usually connotes rents which were for one reason or another depressed below market levels in the base year that the regulation system takes to represent pre-rent stabilization conditions.

²See, Cotati Alliance For Better Housing v. City of Cotati, 148 Cal.App.3d 280; 195 Cal.Rptr. 825 (Oct. 1983), especially p. 293.

³Ibid.

⁴City of Cotati, Rent Appeals Board Amended Rules And Regulations Pursuant To Cotati Municipal Code Chapter 19.12, February 1987, p. 4. Note, however, that in making this shift in its indexing

Unlike the Santa Monica Ordinance, therefore, the Cotati AGA mechanism now allows for maintenance of average landlord NOI in real terms (i.e., adjusted for inflation). However, since the standard applied in the event of a successful IRA petition remains well below 100% of the CPI-U, Cotati now apparently offers little if any incentive to seek individual relief if a particular landlord's NOI has not been effectively indexed by the AGA because it appears that it would be an extremely rare case for that AGA not to result in a more favorable result than a successful IRA petition.

Turning finally to Berkeley, it has already been observed that it is the only one of these six cities which treats only landlord operating expenses in its AGA process. Therefore, it is the only one in which neither the CPI-U nor any other general price index is brought into play to adjust rents absent a landlord petition. The Berkeley Ordinance allows for consideration of a variety of landlord cost factors, including utility costs, property taxes and operating expenses, but it specifically excludes treatment of debt service costs as operating expenses for inflation adjustment purposes, and it provides no method of indexing the profit component of NOI.⁵ The effects of inflation on these items may only be offset as a result of a successful petition for an IRA.

It is at the point where it authorizes such petitions that the concept of NOI is first introduced into the structure of the Berkeley Ordinance and Regulations. The aforementioned Regulation 1264 announces its purpose as assuring "Maintenance Of Net Operating Income," and sets forth the procedures for preparing

policy, Cotati did not make a similar change in its definition of "fair return" to the landlord. Thus, Cotati now provides for indexing of NOI at 100% of the CPI-U, but still defines fair return at the old figure of 55%.

⁵See Section 11, Measure G - Ordinance 5467-N.S., Tenants Rights Amendments Act of 1982.

and filing such petitions. The Regulation allows the successful petitioner's base year NOI to be increased by an amount equal to 40% of the change in the CPI-U. Thus, the impact of the CPI-U as an inflation adjustment in Berkeley is partial and limited entirely to rents influenced by successful IRA petitions.

B. Ordinances Without Explicit Provisions To Adjust NOI

The remaining seven California cities shown in Table I do not attempt to define NOI because their regulation is carried on entirely in terms of rents charged, not landlord expense or net income. All of these jurisdictions allow vacancy decontrol of units and utilize a variety of annual rent adjustment mechanisms for units which are not vacated.

Three of these cities rely on legislated increases which either allow for annual consideration of a wide assortment of data sources (e.g, vacancy rates, operating costs, the CPI, etc.), or simply specify a fixed, quantitatively expressed annual increase. The City of Hayward falls into the first category, while Oakland and San Jose rely on fixed ceilings on annual rent adjustments that have been modified periodically by policy makers.

The remaining four municipalities in this category make annual rent adjustments that are based on changes in the regional CPI-U, though often constrained within legislated bands of permitted minimum and maximum increases. In San Francisco, for example, the standard is 60% of the regional CPI-U, but the resulting rent change may not be less than 4% or more than 7%. Other jurisdictions employ different combinations of these adjustment mechanisms.

However, it should be noted that, since all of these municipalities permit vacancy decontrol and there is significant annual turnover in tenancies (15-30% in most years), the primary deter-

minant of trends in long-term average rents is the turnover rate, not the annual rent adjustments permitted in units which are not vacated. In these cities the primary role of the annual adjustment process is to determine by what margin rents in periodically vacated units diverge over time from those charged for units which have not been vacated and therefore never adjusted to market levels.

2. Selected Jurisdictions Outside California

As shown in the bottom panel of Table I, rent control ordinances and regulations for seven jurisdictions outside California were also reviewed with respect to their NOI indexing provisions. It will be noted that six of these seven have chosen to make their annual general adjustments in terms of rents charged, not landlord costs or net income. Only Cambridge, Massachusetts employs an AGA system similar in general concept to Santa Monica and Cotati in California, where the object of AGAs is direct adjustment of these landlord costs and net income proceeds. The share of the regional CPI-U by which Cambridge AGAs allow for indexing of NOI falls between those of Santa Monica (40%) and Cotati (100%), at 85%.

Despite the strong tendency in the group to direct AGAs to rents, however, the Table also shows that three of the seven jurisdictions define NOI and use the concept for more restricted purposes. Apparently only Cambridge uses NOI as a rigorous quantitative factor in a formula which produces the permitted adjustment. The other two NOI-definers -- Brookline and Boston -- reportedly define and calculate NOI, but then mix it together with a number of other factors taken into consideration in fashioning either a legislated AGA (Brookline) or an individually tailored IRA (Boston). A fourth jurisdiction, New York City, employs a method for calculating what it calls Maximum Base Rents

on older apartments which generates an arguable surrogate for NOI, but NOI is nowhere actually referred to or defined in the New York Regulations.

Although the Brookline Ordinance allows for consideration of a variety of factors in making AGAs, the stated objective of such an adjustment is to yield landlords a "fair net operating income."¹ Brookline IRA procedures are more specific however, clearly allowing for maintenance of NOI at 100% of the change in the CPI, as specified in the City's Rules For Landlord Petitions. Cambridge specifies a more formal AGA process which allows for AGAs that account for 100% of operating cost increases and, as noted above, NOI adjustment equal to 85% of the increase in the CPI. In the Cambridge IRA fair net operating income proceedings, NOI is adjusted by 100% of the increase in the CPI.

The treatment of NOI in the AGA process is more complicated in the case of New York City, which has two regulatory systems in place to control rents. The older and smaller regulation regime, known as the Rent Control program, was established after World War II and now covers approximately 100,000 units built prior to 1947. This program allows rent adjustments pursuant to an annual unit-by-unit procedure known as a Maximum Base Rent analysis, which is designed to provide rental property owners with a cash flow equal to 8.5% of the equalized assessed value of the property. Since cash flow can only be determined after accounting for operating costs and debt service costs, a maintenance-of-NOI standard is implicit in the Maximum Base Rents system.

¹By-laws of the Town of Brookline, Article XXXVIII - Rent and Eviction Control, Section 5. Maximum Rent.

New York's newer and much larger Rent Stabilization program was enacted in 1962 and now covers approximately 1.2 million apartment units in the City.¹ Its AGA process for stabilized units is primarily focused on accounting for increases in operating costs. Although other factors may be considered in the AGA process, NOI is not specifically considered.

Boston allows for NOI indexing, but only in IRA fair return proceedings to maintain base year NOI. Adjustments are first made through an AGA process that focuses on rents and allows for increases equal to 100% of the change in the regional CPI-U.

Finally, three of the selected non-California jurisdictions, Washington, D.C. and Newark and Jersey City, New Jersey, make no reference to NOI in either their AGA or IRA procedures. Washington D.C. allows for AGAs in rent equal to 100% of the CPI-W², up to a maximum of a 10% increase in any given year. The New Jersey AGA procedures are less generous. Jersey City allows for AGAs equal to 100% of the CPI-U but only up to a maximum of 4% in any year. Newark does not connect either rents or NOI to any price index, but has simply legislated a 4% maximum annual increase for buildings with fewer than 50 units and a 5% maximum for buildings with 50 or more units.

¹When rent controlled apartments are vacated, they are decontrolled and become subject to the provisions of the Rent Stabilization program. Thus over time, the stock of rent controlled units will fall to zero and the number of stabilized units will increase by the same amount.

²The CPI-W is a less general cost of living indicator than the CPI-U because it is limited to urban wage earners, especially clerical and sales workers.

3. Conclusory Observations

This review of current municipal rent regulatory practice within California and in selected jurisdictions elsewhere in the country suggests the following general observations:

(a) The nearly universal method of indexing for inflation, if the jurisdiction elects to index for inflation, is the general, across-the-board annual adjustment, not the individual petition process.

(b) The dominant object of such indexing is rent, but there are jurisdictions in California and elsewhere which seek to index landlord NOI, operating costs, or both.

(c) Where vacancy decontrol is permitted, indexing of rent is uniform, but where vacancy decontrol is barred or only partial, jurisdictions differ as to whether they index rent or expenses/NOI.

(d) Where landlord expenses are directly indexed, the index rate is 100% of the measured change in local expenses.

(e) Where NOI is directly indexed, the CPI-U is the standard price index employed, and the share of it that is permitted ranges from 40% to 100%, though it seems to be clearly rising over time.

These observations are made for informational purposes only at this point. It is not suggested nor implied that BRSB is bound to follow any particular policy pattern simply because it may be in use elsewhere.

IV. Specific Issues Assigned for Consultant Analysis

This section is addressed to the questions in HR&A's work assignment from BRSB that are concerned with the appropriateness of various kinds of price and cost indices for the purpose of inflation indexing in rent regulation regimes. The section also traces the actual behavior of leading examples of such indices during the years 1978-1991.

1. Regional vs. Jurisdiction-Specific Indices

In theory, any index of inflationary change in prices or costs over time could be local, regional or national in scope. However, the foregoing comparative snapshot of rent regulation regimes in California and elsewhere in the country demonstrates that a single threshold question has largely determined each regime's balance between use of indices specific to the local jurisdiction, as against regional indices.

This question is whether the locality does or does not seek to make its annual general adjustments directly sensitive to the behavior of landlord operating costs. If the locality does wish to base its general adjustments at least in part on changes in these costs, it usually sets up a process to try to track or infer cost behavior in the specific local context. If, on the other hand, the locality chooses to regulate only rents charged, without reference to the particulars of the cost situation of local landlords, it normally relies on regional price indices computed and maintained by Federal authorities.¹

¹Of course, the comparison also shows that there is a third option adopted by some localities, which is not to index for inflation at all. These jurisdictions, several of which are in California, simply legislate ceilings on rent increases which remain fixed unless and until new legislation changes them.

Note that this question occurs in the context of general adjustments for inflation -- AGAs -- not adjustments secured by individual petition. The petition process can be used to generate operating cost information highly specific to the petitioning landlord; it creates no pressing need for a broader index of local cost behavior.¹ If the main focus of the petition process is on NOI, as it usually is in jurisdictions which do not regulate rents only, the landlord can be and usually is required to present information on operating costs which regulators can take into account in the course of determining the legitimacy of the petitioner's claim to have received unacceptably low NOI even after the AGA has been applied to rents. It is only in a context where this kind of specific showing has not been made -- as in the case of fashioning a general annual adjustment covering thousands of landlords, most of whom will not file IRA petitions -- that jurisdictions which are very interested in cost behavior develop a strong felt need for a cost index.

Still, this does not yet explain the desire for a local rather than a regional or national index of the behavior of landlord operating costs. Some regional and national indices of this kind do exist, as exemplified by the one regularly published by the Institute of Real Estate Management (IREM). Indeed, in Berkeley and elsewhere some cost factors and weights are often taken from such indices as IREM's by local rent regulation authorities in order to fill in holes in locally generated data or weighting information used to compile a local index. Nevertheless, localities that seek to attune AGAs to the behavior of landlord operating costs usually strive to make their cost indices as locality-specific as possible.

¹This is not to say that such an index is not useful as a point of comparison.

The dominant reason for this tendency, in the consultants' judgment, is that the actual behavior of landlord operating costs is often one of the most contentious issues in the policy debate which leads to the adoption of a rent regulation regime. Particularly in smaller urban jurisdictions with a distinctive character that may be dissimilar from the average or dominant physical or socio-economic characteristics of the surrounding metropole, the issue of what is actually happening to the costs borne by local landlords tends to be a much harder-fought issue than the local effects of general price inflation. The same special heat often characterizes the related issue of the behavior of local landlord NOI. Some factions in the debate are often unwilling to accept a regional or national index as an accurate monitor of these impacts because they do not believe that such an index can accurately portray inflationary effects on landlord costs in the special circumstances of the locality.¹

Indeed, the relative strength or weakness of this sentiment often determines whether a rent regulation regime will try to base AGAs on the behavior of landlord costs and NOI, or choose to focus AGAs entirely on the behavior of rents. Where such sentiment is very strong, the twin results tend to be (a) AGAs which are sensitive to operating costs and NOI; and (b) an attempt to develop and maintain a locality-specific index of operating cost behavior suitable for use in the AGA-setting process. As we have seen, Berkeley, Santa Monica and Cotati exemplify this phenomenon in California.

¹This commentary is not intended to imply that this concern is always unjustified. The IREM operating cost index mentioned above, for example, tends to be more reflective of costs in larger than in smaller buildings because of the way that the index is compiled. It is perfectly reasonable to observe that such an index will not be as accurate a barometer of actual cost behavior in a city like Berkeley as it is in a larger city with a higher proportion of large multifamily residences.

With respect to the impact of general price inflation on landlord NOI, on the other hand, no intense desire for a localized price index has generally developed, even in the same jurisdictions which want a localized cost index. This difference starts from the fact that, whereas all costs incurred by owners of local property can be said to be incurred locally, not all owners live in the locality or even in the region. Thus, landlords may find the purchasing power of the income earned from the property affected by inflationary impacts that are more like the regional average than the local one. Moreover, and at least as important in shaping attitudes on this point, there are usually no authoritative price indices available from Federal, State or other sources which are specific to smaller localities. For these reasons the policy debate about which price index to employ has almost always come down to which regional disaggregation of a Federally-maintained index to rely upon.

One of two situations has resulted in the regulation regimes examined: (a) total reliance for all inflation indexing upon a single regional price index; or (b) joint reliance upon such an index plus a locality-specific index of landlord operating costs. The research for this study has uncovered no example of a jurisdiction which undertakes to compile a locality-specific price index. Similarly, it has revealed none which depends for its landlord cost data entirely upon a regional or national index.

2. Compiling Localized Operating Cost Indices

The decision by a locality, particularly a smaller one, to create and maintain a localized index of operating cost behavior invariably poses a tradeoff between accuracy and the overhead cost of creating and updating the index. As demonstrated earlier

in the report, there has been no disagreement that the intended use of the index is to permit rents to pass through to tenants 100% of any changes (increases or decreases) in what the regulatory system designates as legitimate operating costs. The problem is how to establish what those changes have been without incurring what are deemed to be unacceptable overhead costs.

Here again, there has been a threshold question -- though one invariably answered in the same way by the California jurisdictions examined which have created localized cost indices. The question is whether to base the index on current comprehensive actual cost information requested from and reported by a statistically valid sample of local landlords, or to base it upon a composite of actual data gleaned from tax receipts and other information, together with imputed and estimated factors drawn from local, regional and national sources.

All three of the California jurisdictions treated herein which try to track landlord operating costs for AGA-setting purposes -- including Berkeley -- have chosen the second of these two courses. None of them have established annual or periodic surveys of the actual cost experience of local landlords. Rather, all have tapped local, regional and national data sources to create a composite base of data, factors and estimates which they have used to calculate the cost behavior estimates which they have then built into their AGAs.

However, none of these jurisdictions have selected the same composite of sources of information or estimates. In Berkeley, the only one of them where the consultants have analyzed the history of these calculations, the makeup of the composite has changed significantly over time. New types of costs have been added, different data sources have been tapped, and numerous other changes in methodology have been introduced. Although the consultants believe that the net effect of these changes has probably been to make the more recent calculations more defen-

sible technically than their predecessors, the series of annual cost estimations does not represent an analytically continuous whole in which each of the annual links bears either great similarity or readily explainable dissimilarity to all of the preceding links. And, presumably because of the overhead cost involved, at no time has the whole calculation process been validated through comparison to actual average landlord cost experience either in the base year or in any year since. It is impossible to know, therefore, to what extent the current Berkeley operating cost estimation process generates accurate results.

A brief review of the history of the Berkeley cost estimation analysis shows the basis of this observation. The Berkeley Rent Stabilization Board has commissioned annual studies of operating costs since the adoption of the current Ordinance in 1980. But the first two studies, made in 1980 and 1981, are not directly comparable to the more formal operating cost studies that have been prepared since.¹

In 1982 an attorney with extensive experience in these matters was retained by the Board to prepare formal detailed operating cost studies, an assignment he carried out for each of the next five years. He and his associates identified 13 distinct elements of operating cost, which are shown in Table II on the next page. From the data sources listed in Table III on the following page, operating cost weights were estimated for each operating cost element. (The weights are simply the percentage share of each cost element relative to gross rents. For example, a property tax weight of 6.7% is implied if 1981 annual gross

¹Specifically, the first two studies do not rely on empirically derived percentage ratios of operating cost items (e.g. property taxes) to rental income (usually termed expenditure weights), or to actual changes in operating costs in Berkeley. The 1980 study relies on aggregated expenditure weights for properties in Santa Monica and on changes in costs in Berkeley. The 1981 study, by contrast, is based entirely on changes in the CPI.

TABLE II

Table II Berkeley Residential Rental Properties Data Sources For Operating Cost Weights: 1980-81	
Cost Share Element	Data Source
1. Property taxes	Sample of registered buildings
2. Library taxes	Sample of registered buildings
3. Refuse collection	Sample of registered buildings
4. Water service	EBMUD ^a tabulation
5. Sewer maintenance	EBMUD tabulation
6. Sewer treatment	EBMUD tabulation
7. Business license fee	Actual rate (percent of gross receipts)
8. Rental unit registration fee	Fee / avg. rent
9. Insurance	MLS ^b ; IRA petitions; Mgt. Co. survey ^c
10. Management	IREM ^d ; MLS; IRA petitions; Mgt. Co. survey
11. Maintenance, repairs, and other	IREM; Mgt. Co. Survey
12. Gas service	Mail survey - utility users
13. Electricity service	Mail survey - utility users
Source:	<i>BERKELEY RENT STABILIZED PROPERTIES OPERATING COSTS AND DEBT SERVICE</i> , Kenneth Baar, et al., September 2, 1982
Notes:	^a East Bay Municipal Utility District
	^b Multiple Listing Service - Berkeley Board of Realtors
	^c Results of mail survey to 11 property management companies with rental properties in Berkeley - one response.
	^d Institute of Real Estate Management, <i>Income Expense Analysis</i> , 1981 ed.

TABLE III

Table III Operating Cost Expenditure Weights 1981 And 1990^a		
Expenditure Items	1981 Expenditure Weights	1990 Expenditure Weights
Property Taxes - Same Owner	0.0670	0.0701
Library Taxes	0.0063	0.0124
Refuse Collection	0.0200	0.0315
Water	.01200	0.0124
Sewer Maintenance	0.0090	0.0417
Sewer Treatment	0.0090	0.0111
License Fees	0.0063	0.0108
Registration Fee	0.0036	0.0227
Insurance	0.0340	0.0650
Management	0.0700	0.0954
Maintenance & Repairs	0.1400 ^b	0.0863
Landscaping/Street Assessment	0.0000	0.0180
Gas - Hot Water Only	0.0340	0.0180
Electricity - Common Area	0.0300	0.0240
School Assessment	0.0000	0.0170
Mosquito Abatement	0.0000	0.0001
Vector Control	0.0000	0.0010
Paramedical Care	0.0000	0.0019
EBMUD Wet Weather	0.0000	0.0048
Fire Inspection Fee	0.0000	0.0048
Total (For Buildings with Common Area Utilities Only)	0.4412	0.5490
Sources:	BERKELEY RENT STABILIZED PROPERTIES OPERATING COSTS AND DEBT SERVICE , Kenneth Baar, et al., September 2, 1982 and INCREASES IN OPERATING COSTS OF BERKELEY APART- MENTS , John Gruenstein, et al., October 1, 1990.	
Notes:	^a Unmodified operating cost expenditure weights for buildings with common area utilities only and no change in ownership. ^b Adjusted to reflect reassessment of weight made in following year.	

rents equaled \$10,800¹ and property taxes in the same year were \$724.²) A separate set of data sources were consulted to estimate the percentage increase in each cost element. For example, rate sheets for the local electrical utility were consulted to determine how much electric rates increased. The AGA required to fully account for the increase in all 13 operating cost elements was estimated by multiplying each cost weight by the percentage increase in the respective cost element.

The original 1981 cost weights were adjusted in each year thereafter to reflect the proportionate cost increase in each weight relative to the AGA granted by the Board. Thus, the weights for cost elements which increased more rapidly than the AGA change were adjusted upward and the weights for cost elements which grew more slowly than the AGA were adjusted downward.³ As additional operating cost elements were added, e.g., the school assessment, they were incorporated into the operating cost studies.

In 1988 an economist was hired by the Board to prepare the annual operating cost study. He has continued in this role through 1990. In the 1989 study, he and his associates reesti-

¹This assumes a median 1981 rent of \$226 per month for a four unit building.

²This assumes the average property tax weight from the attorney's 1982 operating cost study.

³The general formula for a given cost element was:

$$(\text{Cost Weight} \times (1 + \text{Cost Increase})) / \text{AGA} - \text{Revised Weight}$$

For example, assume a property tax weight of 6.7% an annual increase (limited by Proposition 13) of 2%, and an AGA of 5%. The revised property tax weight is then equal to:

$$(.067 \times 1/02) / 1.05 = .065$$

If the AGA (5%) had been less than the increase in property taxes (2%), the cost weight would have increased rather than shrinking from 6.7% to 6.5%.

mated the operating cost weights using the same basic approach initially used by his predecessor in 1982. This reestimate showed that a number of taxes had not been added into the operating cost base, including those for mosquito abatement, paramedical care, vector control, and the East Bay Municipal Utility District (EBMUD) wet weather program.¹

The number of expenditure elements used in the annual estimates increased from 13 in 1981 to about 20 in 1990. In the latter year, the expenditure weights were updated using the proportionate cost increase method described above. The actual values for the 1990 and 1981 expenditure weights are shown in Table III. In total, the operating cost weights indicate that the percentage of rents required to cover operating costs (a share referred to by real estate investors as "the operating ratio") was estimated to have increased by about 24%, from 44% in 1981 to 55% in 1990. By definition, therefore, the percentage share of gross rents represented by landlord NOI has fallen from 56% to 45%, or by about one-fifth.

These Berkeley estimates may be compared to the operating cost data that IREM collects from its participating member real estate managers across the country. These data are used by property managers and owners and real estate analysts for management purposes and as general indicators of the health of the rental housing industry. Unfortunately, IREM does not report operating cost data for Berkeley, but data for the operating results of San Francisco properties are available. Although the basis for comparing the IREM data with the performance of rental

¹See J. Gruenstein, D. Lai, and BPA Economics, Expense Ratios And Operating Cost Increases of Berkeley Apartments, October 2, 1989.

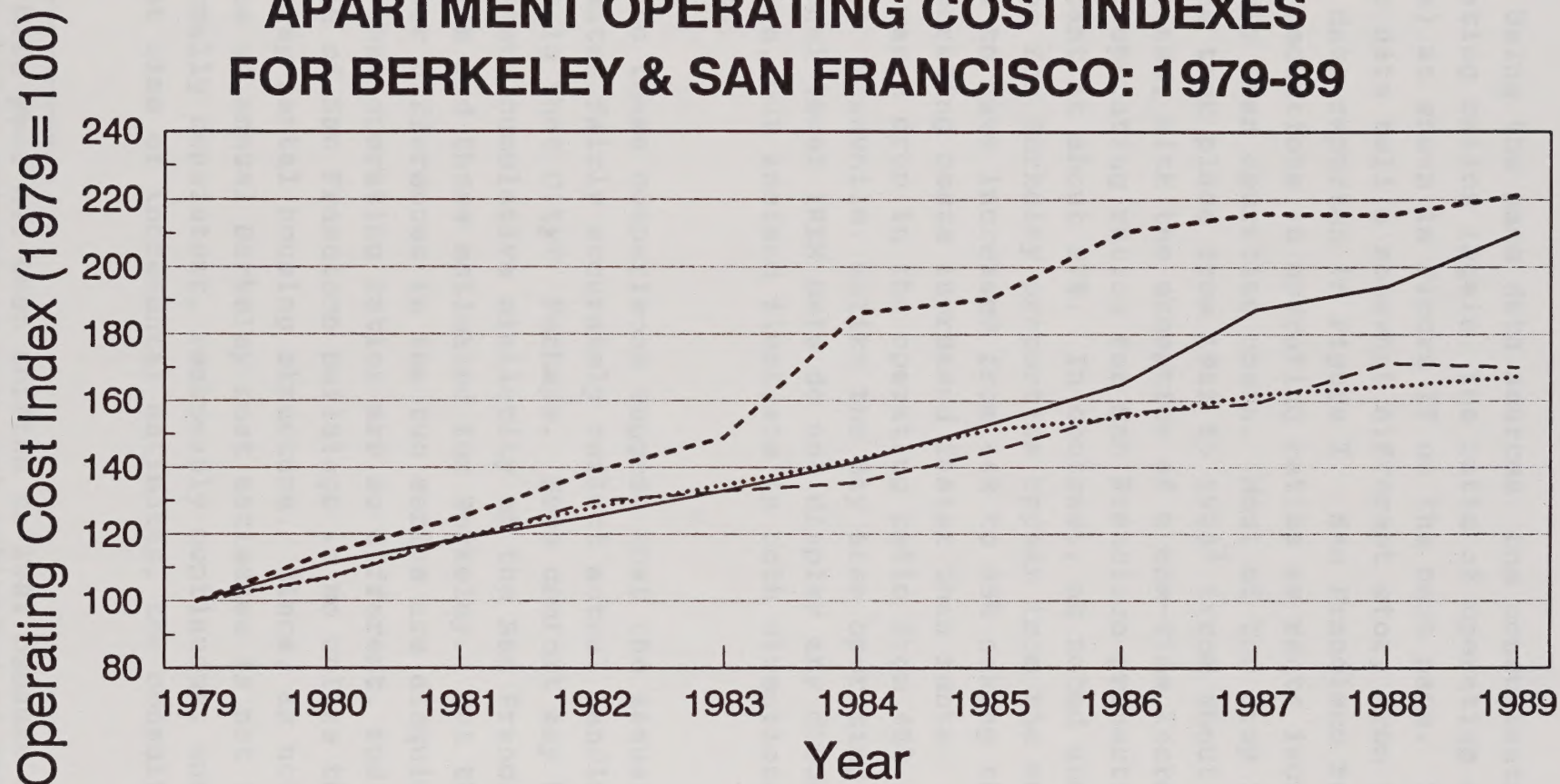
properties in Berkeley is far from perfect,¹ the broad themes related to changes in operating costs and operating ratios may be instructive.

Reported and estimated changes in operating costs from 1979 to 1989 are compared for a variety of property types in Figure I on the next page. The property types include all participating IREM properties in San Francisco, together with national IREM data for garden apartments and low rise 12-24 unit properties. Operating cost increases for Berkeley properties have been estimated from a review of the annual operating cost studies commissioned by BRSB.

The Figure I comparison of the San Francisco IREM reports and the Berkeley estimates suggests that operating costs increased by about the same amount in the two locations over the full 1979-1989 period. Although the annual increases differ quite noticeably, the cumulative results over the ten-year period do not. The net result in 1989 is a 110% increase in Berkeley and a 121% increase for San Francisco properties. The national-level IREM data suggest much lower rates of increase in operating costs, about 70% below that of the Bay area properties. These differences probably reflect the higher costs associated with large mature metropolitan areas such as the San Francisco Bay, relative to the lower cost conditions experienced by the less urbanized portion of the IREM membership. The national results are consistent internally however, and report comparable percentage increases in operating costs for both building types -- about 67% for garden apartments and 70% for low rise 12-24 unit properties.

¹By comparison to rental properties reported by IREM, Berkeley properties have fewer average units and are less likely to be professionally managed. Furthermore, the IREM data may suffer from sample selection bias (differential responses from some portions of the IREM membership) and inadequate sample size (e.g., 48 buildings were included in the 1981 report).

FIGURE I
APARTMENT OPERATING COST INDEXES
FOR BERKELEY & SAN FRANCISCO: 1979-89



Berkeley Operating Cost Studies

IREM - San Francisco

IREM National - Garden Apts.

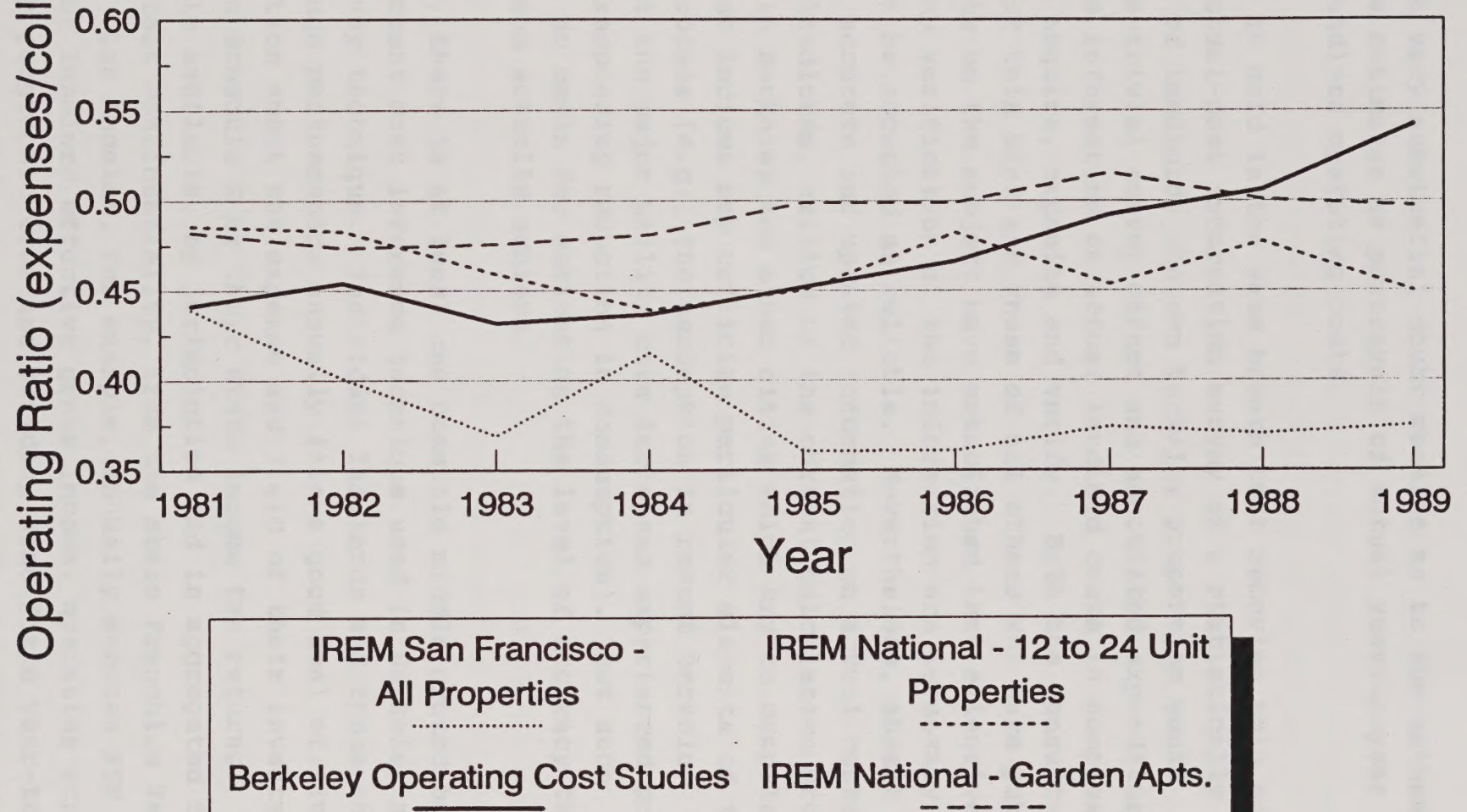
IREM National - 12 to 24 Unit Properties

Using the same data sources, the consultants plotted operating ratios (again, the ratio of operating expenses to gross rents) as shown in Figure II on the next page. The operating ratio data tell a somewhat different story from the operating cost data reported in Figure I. San Francisco recorded significant reductions in operating ratios as rents increased more rapidly than operating costs. Most of the drop in operating ratios took place from 1981 to 1983¹ (from about 42% to about 37%), and, with the exception of a one-time increase to 42% in 1984, operating ratios for San Francisco properties remained constant at about 37%. In contrast, as noted above operating ratios for Berkeley properties appear from the annual cost estimates to have increased from 44% to 55% during the same period, as operating costs increased faster than rents. (The sole exception was a drop in the operating ratio from 45% in 1982 to 43% in 1983.) Meanwhile, unlike the Bay area operating ratios, the national level IREM data do not display any discernible trend up or down, but instead fluctuate in both directions over the period.

Do these comparisons suggest that the annual Berkeley cost estimates fairly accurately reflect actual landlord cost experience in that City? Perhaps. Some comfort may be taken from the long-term cumulative similarity of the San Francisco IREM cost figures and those estimated for Berkeley. But the large year-to-year differences in the two series are disquieting. So is the fact that operating ratios are so different, and that the IREM sample of San Francisco buildings is so unlike the average Berkeley rental housing structure. Since, as noted earlier, the series of annual Berkeley cost estimates is not in itself an internally consistent, reasonably continuous, analytically coherent line of incremental estimates, the consultants can only

¹The base year has been shifted to 1981 because operating ratios for Berkeley properties were not estimated as part of the annual operating cost studies until that date.

FIGURE II
OPERATING RATIOS FOR SEVERAL JURISDICTIONS
AND PROPERTY TYPES: 1981-1989



conclude that very substantial doubt remains as to the authenticity of these estimates as portrayals of actual year-to-year changes in landlord operating costs.

It must be said in the same breath that removing this doubt through an actual-cost information survey of a statistically valid sample of landlords who own Berkeley properties would require a non-trivial survey effort and associated expenditure. Comprehensive information on actual landlord costs is complex and difficult to acquire, organize and verify. Both the consultants' own efforts of this kind and those of all others who have published reports on the subject have established that extensive "cleaning" and verification of the information are necessary before it can be accepted as reliable. Nevertheless, absent demonstrably accurate and updated information on actual costs incurred by landlords, critics of the current calculation processes used in Berkeley and other cities which try to compile localized cost indices may criticize particular elements of the estimating process (e.g., the assumption in recent Berkeley analyses that the major utility rate increases experienced produced no corresponding reduction in consumption). But such critics have no basis for estimating the level of accuracy that these processes actually achieve.

However, there is at least one possible middle ground between the current cost inference technique used in Berkeley and the cost survey technique. Individual landlords and those who operate through partnerships annually file a good deal of financial information about the expense and yield of their investment properties in Schedule E of their State income tax returns. This information is available, by jurisdiction and in aggregated form so as to protect confidentiality, from the State Franchise Tax Board (FTB). Los Angeles, for example, annually secures FTB tabulations of landlord effective gross income, operating expenses and NOI by geographic area and building size for a year-to-year linked sample of about 4,000 properties in the City. The

requesting jurisdiction must pay a fee charged by FTB for this service, which reportedly is keyed to the size and complexity of the data set requested.¹ Berkeley could presumably order and receive similar FTB services if the City wished to do so.

While very useful, FTB data necessarily introduce a bias into their reflection of reality which is roughly opposite to the bias of IREM operating cost data. This is because FTB filings capture only properties owned by individuals and partnerships, not those owned by corporations. Since corporate-owned properties tend to be larger and more often professionally managed than individually-owned ones, the FTB data set understates such buildings in compiling its average cost and NOI figures, just as IREM data tend to do the reverse.² But operating costs in the Berkeley rental stock, which reportedly features an unusually high incidence of individual owners, may be more accurately portrayed by FTB data than is true of larger cities or ones with more large, corporate-owned developments. At the very least, FTB data would be a very interesting check on the output of the annual Berkeley operating costs inference effort.

Also, FTB data would probably be more nearly accurate as an indicator of City-wide conditions than the data drawn from the cost information submitted from petitioning Berkeley landlords that are now sometimes incorporated into the inference procedure. Because petitioners make up a very small fraction of Berkeley landlords and there is no technical reason to believe that this fraction is representative of all landlords -- indeed, there is

¹The set ordered by Los Angeles reportedly costs the City about \$40,000 per year. It is not known what charge FTB would make for a data set attuned to Berkeley's needs.

²This is why Los Angeles customarily checks its operating cost information against both types of data in the course of the periodic studies that the City commissions to establish and update information on costs, rents and other aspects of its rental housing stock. HR&A has performed both of the two studies of this kind which have been performed to date, the first in 1984-85 and the second in 1988.

reason to believe that it is not representative -- the FTB data are to be preferred because, assuming a valid sample is drawn, this information is at least reflective of the circumstances of individual landlords. The issue of accuracy of reporting still arises in the case of FTB data, as it does with respect to any method of collecting landlord cost information, but the risks and sanctions involved in willful inaccuracy are at least as great in the case of income tax filings as in any other form of general information collection from a given population.

Because FTB data for Berkeley have never been requested or procured by BRSB, the consultants have been unable to check the annual Berkeley cost studies against this promising potential source of information.

3. Selecting Among Regional Price Indices

Turning from cost monitoring to the choice of a general price index used as an additional or substitute inflation adjustment tool, the consultants were asked to investigate the possibility of a locality-specific or sub-regional price index which might be considered for introduction into the Berkeley indexing technique. However, a search extending to a wide variety of data sources was unsuccessful in identifying a general price inflation index that is either locally generated or broader but sufficiently disaggregated to be specific to Berkeley, to Alameda County or to the East Bay sub-region. (The sources consulted in this search are listed in Appendix I to this report.) As a result, this section concentrates only on possible regional components of Federally maintained national indices.

The earlier comparative analysis showed that the Consumer Price Index for all urban consumers (CPI-U) is a widely accepted and utilized measure of general price inflation in the rent regulation field. This index is compiled and reported at the regional and national levels. The cost data are collected by the

U.S. Bureau of Labor Statistics using expenditure weights derived from the Consumer Expenditure Surveys and surveys of prices gathered from 57,000 households and 19,000 business establishments which serve consumers. Prices are collected on a monthly basis for food, clothing, shelter, energy, transportation and various consumer services. As previously reported, the CPI-U is the inflation index of choice for most jurisdictions which engage in rent regulation, whether they focus solely on rents or on operating costs and NOI.

An arguably more tailored version of the same index is the CPI-U minus the component of it which reflects the prices charged for owned or rented shelter.¹ (This is referred to henceforth as the CPI-U-S). Though sometimes proposed, this variant on the CPI-U has apparently never been adopted by a rent regulation regime. The advantage usually cited for it is that it avoids the circularity of permitting regulated rents to be tied to an index which is influenced by the behavior of other housing costs, both regulated and unregulated. The disadvantage of the variant is that it is little known and even less understood. Non-technicians tend to react more positively to indexing by the well recognized CPI-U than by a variant on it. Nevertheless, the CPI-U-S is no less available or solidly based than the full CPI-U.

¹A further refined version of the CPI-U would be that index less only the rental component of shelter prices. This would omit owner-occupied dwellings, thereby arguably tailoring the index even more closely to the purpose of rent regulation. Federal authorities report that this more refined index would be possible to calculate from available data, but only through some complex manipulations involving the sequential reweighting process that the index compilers carry out. This and all following discussions of a CPI variant of this general variety refer to one in which the entire shelter price subcategory is removed -- a CPI variant which is included in regular Federal CPI reporting. However, BRSB may wish to consider use of the more refined version if the complexities involved in calculating are deemed acceptable.

A number of other indices exist at the national level which could be used to make adjustments for the effects of inflation. One, which could be persuasively argued to be superior until relatively recently, is the Personal Consumption Expenditures (PCE) component of the GNP-Deflator. This Deflator is the most general measure of price inflation at the national level and is used by the U.S. Bureau of Economic Analysis to adjust Gross National Product to real terms. Since the GNP-Deflator accounts for economy-wide changes in prices, wholesale and retail, it is not an appropriate measure of changes in consumer prices. However, the implicit price deflator for Personal Consumption Expenditures (PCE), which constitutes the "consumer side" of the GNP-Deflator, might be considered worthy of consideration. The PCE differs from the CPI-U in that it: (a) encompasses a broader definition of consumption which includes rural households and non-profit organizations; (b) relies on expenditure weights derived from different consumption data and time periods; and (c) is compiled using somewhat different technical assumptions and procedures.

Prior to the adjustment of the CPI-U which was made in 1983 to account for the costs of owner-occupied housing on a rental equivalence basis rather than an asset-price basis, the PCE index could easily be argued to be technically superior to the CPI-U because the unadjusted CPI-U index overstated changes in the cost of owner-occupied housing caused by rapid price increases in that market. As a consequence, general price inflation was also overstated by the CPI-U.¹ However, since this change, the CPI-U is widely argued to be superior for analyses at sub-national

¹Using changes in asset prices as a basis overstates changes in housing costs because many households already own housing and are consequently insulated from price changes that may affect non-homeowners. This bias is accentuated during periods of rapid appreciation of home values such as the late 1970s, and even more accentuated in areas like California where this appreciation was then most pronounced.

levels because it is based on regional changes in the cost of living rather than on the national changes measured by the PCE index.

The only other price index that the study has found in use by a major rent regulating jurisdiction is the CPI-W used in Washington, D.C. As noted above, this is a CPI variant which emphasizes the price experience of urban workers, particularly those who perform clerical tasks. Whereas there may be some argument for applying this variant in a city like Washington, in which government office workers and their private service sector counterparts are very prominent in a local economy which features little other major industry, the same argument would not seem to apply to a city like Berkeley.

In the end, therefore, the consultants have not uncovered either a locality-specific or a regional/national general price index which can be argued to be superior to the CPI-U for the San Francisco-Oakland-San Jose region. The only issue remaining in this area is whether the better price index for this purpose is the CPI-U or the CPI-U-S, which removes shelter prices in order to avoid circularity. The consultants' views on that issue are contained in the recommendations at the end of this report.

4. Use of Full vs. Partial Price Index Readings

The comparative analysis established the CPI-U as the overwhelming choice among general price indices used by rent regulating localities. But it also showed that jurisdictions differ as to whether to use 100% of the annual change registered by the index during the period in question, or to employ some lesser fraction of that change. The comparative analysis further revealed that this choice was not dictated by whether the locality elected to index rents or to index landlord NOI -- full and partial readings are used by some jurisdictions which choose each of these objects to index.

Because the Searle Court specifically held that the fraction of the CPI-U (40%) which Berkeley incorporates into its rent stabilization regime is not adequately justified by the arguments advanced by the City in support of this fraction, the consultants were asked to address this topic directly. They were also asked to address the issue not only in the context of the current Berkeley system which applies a general price index only to landlord NOI, but to include an analysis of the more generic question of the general frequency and technical suitability of the use of partial index readings for purposes of rent regulation. Therefore, this section of the report discusses the policy choices and issues involved in the choice of a full or partial index reading as a tool for indexing inflation, together with examples of how differing localities have made and implemented these choices.¹

It should also be carefully noted that, except where specifically noted, this discussion focuses on the use of full and partial price index readings in the annual general adjustment (AGA) process, not in the IRA process.²

A. Threshold Policy Questions

This area of policy decision making poses the regulating locality with a sequence of three threshold questions. First, the jurisdiction must decide whether it wishes the AGA process to permit all of the elements of the item that it chooses to index

¹This discussion does not imply any judgment as to whether, and if so to what extent, options selected by other localities are legally open to BRSB within the terms of the current Berkeley Rent Stabilization Ordinance.

²As reported earlier, some jurisdictions apply one type of index reading in the AGA process and another type in the IRA petition process component of their regulatory regimes. Cotati, which indexes NOI to 100% in the AGA process and 55% in the IRA process, is an example of this practice.

-- i.e., rents, or landlord costs, or landlord NOI -- to rise at the same rate as consumer prices in the region, or whether it chooses to treat some elements of the indexed item as (i) already adjusted by other means, or (ii) immune to the effects of inflation, or (iii) properly subject to an adjustment rate which lags behind general inflationary trends; or (iv) not subject to indexing for inflation as a matter of policy.

The second threshold question is whether the jurisdiction wishes to permit its chosen level of inflation indexing to take full effect as soon as the volume of inflation experienced is statistically established, or desires to limit the impact on rents that can occur from this indexing in any one year. The final threshold question arises only if the answer to the foregoing question is affirmative, and asks whether the jurisdiction wishes that the financial burden of any limit imposed on the rent increase in any one year be borne by landlords, or shared between landlords and tenants.

B. How These Questions Have Been Answered

The comparative analysis summarized in Table I of this report reveals that their responses to these questions classify all of the jurisdictions compared herein except Berkeley into one of four groups:¹

* Localities which utilize a flat 100% of the index. These jurisdictions draw no distinctions within the indexed item. They permit it to rise to the full extent of the price index

¹This discussion omits a fifth group, which has elected not to index for inflation at all. In the comparative analysis, this course was represented by San Jose, Hayward, Oakland, Brookline, Mass., Newark, N.J., and the stabilized majority of the regulated rental housing stock in New York City. This was also the policy in Los Angeles prior to 1985.

selected. (This policy is followed by Catati, East Palo Alto¹ and Boston among the cities included in the comparative analysis.)

* Localities which apply a flat rate that is less than 100% of the price index change. These jurisdictions also draw no distinction among elements of the indexed item, but treat that item as only partially subject to inflation indexing by means of a general price index. (Santa Monica, Palm Springs and Cambridge, Mass. comprise this group among the localities compared.)

* Localities which start with 100% of the change in the price index, but then constrain² the change in rent which is permitted to result in any one year. (These jurisdictions include Los Angeles, Beverly Hills, Jersey City and Washington, D.C. among the cities compared.)

* Localities which utilize less than 100% of the change in the price index and also impose constraints on any resulting annual change in rent. (These localities include San Francisco, West Hollywood, Los Gatos and Thousand Oaks among the jurisdictions compared.)

Berkeley does not fit into any of these four groups because it alone, among localities which make use of a price index, does not introduce that index into the AGA process. Only for the small minority of Berkeley landlords who elect to petition for an inflation adjustment of NOI does Berkeley fit into the second group of cities listed.

¹It will be recalled that East Palo Alto applies the lower of two alternative price indices (the CPI-U and the component of the CPI-U made up of rent only). But it utilizes 100% of the change reading of whichever alternative index is applicable.

²Note that constraints can include a ceiling, a floor, or both.

Each of these four groups of localities represents a policy subset formed by a distinctive configuration of answers to the three threshold questions. Each subset contains more than one member locality, demonstrating that there is no dominant "school solution" to this range of issues. The order in which the groups are listed above starts with the subsets of cities which have selected a single principle of indexing policy. It then proceeds through the subsets which have opted to meld two, and then those which have incorporated three principles into their indexing regimes. Each group is now reviewed in turn from this standpoint, using shorthand labels as aids to thinking about the policy choices involved.

The cities in the first of the four groups may properly be characterized as "pure indexers." These localities have adopted policies designed to permit landlords to offset the full amount of the change in whatever inflation index each has selected, with no more time lag than the interval between the end of the period of price data covered by the index (usually the preceding year) and the point in time when the AGA is permitted to take effect. Note that each of the three cities in this group has selected a different index: Boston the CPI-U, East Palo Alto the lower of the CPI-U and the rent component of that index, and Cotati a composite of a localized landlord operating cost index and the CPI-U. The changes in rent that each jurisdiction may therefore permit in any given year may be quite different. Nevertheless, they are united from a policy standpoint in their adherence to the principle that rents will be permitted to vary by 100% of what they select as the appropriate measure of the change in the prices paid by landlords.

The localities in the second subset could be termed "partial index users." They have all elected to cut back the actual change in the price index that each uses to reflect the view that some elements of the item indexed are either indexed in another way, or are immune from inflationary impact, or are properly

lagged behind general price developments. However, like the "pure indexers," these cities permit the full effect of the permitted indexing to be felt as soon as those effects are statisically documented, regardless of the scale of percentage change in rents that this may generate.

Most "partial index users" cut back the share of the price index they apply to reflect the fact that they wish to make a similar reduction in the share of the indexed item which is adjusted for inflation in this way. That is, they reason that, since only a fraction of the indexed item is either uncovered by another inflation adjustment device or actually subject to inflationary change, only a similar fraction of the general price index should be applied to offset inflationary impact.¹ It is usually readily agreed in such jurisdictions that it would be preferable from a technical standpoint to divide the indexed item into specific, currently documented segments to be adjusted for inflation in various ways, and then apply the full change in the selected price index to the segment designated for adjustment in this manner.² But this would require much more detailed income about landlord costs (including debt service costs) and net income than most jurisdictions wish to pay the overhead costs necessary to collect. Cutting back the change in a general price index by any fraction, on the other hand, is an extremely simple

¹Berkeley has historically relied upon a somewhat different argument to the effect that changes in landlord NOI have tended to lag behind consumer price trends. Because of its importance in Berkeley, this line of thought is treated later in this section in some detail.

²This preference assumes that the jurisdiction wishes to separate the elements of the indexed item at all. As we have seen, many jurisdictions make no such segmentation, but rather apply inflationary adjustments solely to the total rent charged.

arithmetic operation involving negligible overhead costs. Therefore, this has been the approach selected by the "partial index users."¹

Santa Monica and Cambridge, Mass. are "partial index users" which employ a separate local average landlord operating cost updating procedure to attempt to permit rents to keep pace with changes in those costs. They then use a general price index only to offset inflationary impact on imputed NOI -- that is, on the portion of landlord rental income which they believe to remain after operating costs and debt service costs (which they treat as immune from inflationary impact²) have been paid. Since NOI after payment of debt service is only a fraction of the rent paid to landlords, they seek to reflect this by applying only a fraction of the change in the index. In Santa Monica, this fraction is 40%; in Cambridge, it is 85%.

Palm Springs is a "partial index user" which does not seek to track inflation in local landlord operating costs, but simply indexes rents. However, the City treats a portion of rents paid to landlords as defraying costs that are not subject to inflationary impact -- presumably all debt service costs. These costs are apparently estimated to average 25% of landlord rental income across the rental housing stock. The City attempts to reflect this by indexing rents for inflation at 75% of the annual change in the CPI-U. Like all other "partial index users," Palm Springs makes this inflationary adjustment across the board through its AGA process.

¹As will be seen below, this approach has a non-neutral impact over time on the share of the indexed item which is thereby indexed at a rate which is only a fraction of actual price inflation.

²See below for a more detailed discussion of the relation between inflation and debt service costs.

The cities in the third of the four groups in the typology may be described either as "index smoothers" (Los Angeles) or "index limiters" (Beverly Hills, Jersey City, Washington D.C.) Both of these sub-groups accept the policy principle that inflation effects should be passed through to tenants, but they add a second principle to the effect that the size of the jolt experienced by tenants in any one year should be limited. In other words, they determine that the burden imposed by inflation above a legislated limit should be shared between landlords and tenants. Beyond these common principles, however, the two sub-groups part company.

Those who adopt the "index smoother" approach arguably seek no more than to lengthen the lag before the offsetting of inflationary impact on landlords if a more immediate offset would require a sudden percentage increase in the rents paid by tenants which is higher than the locality considers socially acceptable. By putting both a percentage floor and a percentage ceiling on the permitted adjustment, the "index smoother" jurisdiction makes it at least theoretically possible that landlords will recoup in very low inflation years (i.e., years in which the inflation rate is below the floor rate of annual adjustment) any loss that they absorb in years when the inflation rate is higher than the ceiling on annual adjustments. Of course the probability that such recoupment will actually occur depends upon how high the floor is set, just as the probability that it will be needed

depends on the height of the ceiling.¹ The current Los Angeles limits -- a 3% floor and an 8% ceiling -- seem designed to promote the chances that "pure" inflationary indexing will be permitted unless inflationary conditions diverge markedly from those that have prevailed for the past decade or so.²

The "index limiter" approach involves only a ceiling and not a floor on annual rent increases, thereby permitting no such landlord recoupment in low inflation years. This approach requires that any inflation impact beyond the ceiling rate be absorbed by the landlord alone. Again, both the probability and the extent of this absorption depends on the height of the ceiling. At 10%, the ceilings set by Beverly Hills³ and Washington D.C.⁴ seem intended to avoid constraining "pure" indexing except in conditions of hyperinflation. On the other hand, the

¹Both the need for and the means of landlord recoupment will also vary according to whether the regulating jurisdiction does or does not permit rents to adjust to market levels when the unit is vacated. In the only "index smoother" jurisdiction in the comparative analysis, Los Angeles, this adjustment of rents is permitted, so that any losses suffered by landlords on continuously occupied units in high inflation years may, if market conditions permit, be offset by higher rents charged for vacated units owned by the same landlord. Whether these vacated units will in fact be rented at these higher rates would depend upon the structure of the local rental market, in particular on how many landlords own multiple dwellings and seek to achieve this cross-subsidization among tenants.

²It should be noted in passing, however, that in any documented peacetime period in the 20th Century prior to the late 1970s this ceiling would have been far too high to come into play, while the floor would have been above the actual inflation rate a non-trivial portion of the time.

³The Beverly Hills ceiling is 10% for all units built after September 20, 1978 and all preexisting units which rented for more than \$600 per month in 1978. (Units of both types are classified as "luxury" in Beverly Hills, a category which includes an usually large share of the rental housing stock of that City.) For all other units, the Beverly Hills ceiling is set at 8%.

⁴It should be remembered that the Washington price index of choice is the CPI-W, not the CPI-U.

Jersey City ceiling, at 4%, seems designed to maximize landlord absorption of any inflationary impact much beyond what has come to be seen as a nearly inevitable level of price creep in a growing economy.¹ But, whether the ceiling is high or low, the fact that there is a ceiling but no floor assures that if the ceiling comes into play, there is no means in the AGA process by which landlords can recoup the loss in purchasing power of the income from these units in a later year.² Thus, the effect of this approach is not just to smooth out the lumps in the impact of inflation upon landlords and tenants, respectively, but to visit that impact upon landlords alone to the extent that it exceeds the ceiling.

The jurisdictions in the fourth and final group in the typology break into two similar sub-groups: "partial index smoothers" and "partial index limiters." But all members of the group are united in their attempt to incorporate all of the policy principles adopted by the first three groups combined. That is, the fourth-group localities all (i) use a general price index as one tool to adjust for inflation; (ii) cut back on the actual change in the index as a way of achieving a similar reduction in the share of the indexed item that is subjected to indexing in this manner; and (iii) limit the change in rent which can result from inflation indexing in any one year. All of the localities which fell into this group in the comparative analysis were also united in their indexing of rents, not landlord NOI, in the AGA process.

¹The Jersey City ceiling is also applied in the context of no vacancy decontrol of rents. Thus, there is no possibility of recoupment of landlord inflation losses through cross-subsidization among tenants.

²It is possible to conceive of combinations of high percentages of CPI-U and operating costs which lag CPI increases which would permit landlords to avoid incurring losses under a ceiling-only system. However, these specialized circumstances would not qualify as the general case to be used for analytic or planning purposes.

San Francisco, Thousand Oaks and Los Gatos represent the "partial index smoother" approach within this fourth group. Each uses a share of the CPI-U changes and establishes both a floor and a ceiling on changes in rents in any single year. The three cities differ somewhat as to the percentage of the change in the index they employ (60% in San Francisco, 70% in Los Gatos, 75% in Thousand Oaks). San Francisco and Thousand Oaks apply different floors on annual change (4% and 3%, respectively), but both apply the same ceiling (7%). Los Gatos employs a singular technique in which the permitted inflation adjustment is either the stated percentage of change in the price index or 5%, whichever is greater. This has the effect of establishing a floor of 5% which is also a ceiling unless the change in the CPI-U is greater than 7.14%.¹

The representative of the "partial index limiting" approach within this group is West Hollywood. That City imposes a ceiling but no floor on the single-year impact of applying 75% of the change in the CPI-U to rents as an inflation adjustment. The West Hollywood ceiling is 7% if the tenant pays gas and electricity costs and 8% if the landlord pays both. Since West Hollywood permits only limited vacancy decontrol (a 10% maximum increase once in every five years), the absence of a floor on inflation adjustments allows landlords relatively little recourse for recoupment of any losses suffered in high inflation years.

C. Arguments Advanced in Support of Use of Partial Readings

Reviewing the types of responses to the threshold questions among the four groups of localities establishes that use of only a portion of the change in a price index as an inflation account-

¹If the CPI-U grows faster than this, the Los Gatos ceiling rises at the rate of seven-tenths of a percentage point for every point of increase in the CPI-U.

ing factor is not a rare phenomenon. What are the arguments put forward in favor of this practice, and what is their merit from a technical standpoint?

It must first be recognized that this is a very different question if what is partially indexed are rents, not landlord NOI. The consequences of partial indexing of rents cannot be predicted or assessed with confidence without quite specific information about the other major features of the rent regulation program and the economic and financial characteristics of and trends within the subject jurisdiction. Indexing rents at the same percentage of a general price index can have quite different effects in different localities depending upon the nature of these localized variables. Therefore, it is impossible to respond generically to the above questions where the partial indexing is of rents -- beyond the observation that, precisely because of the variability of results, it would be very difficult, as a technical matter, to determine the appropriate percentage of an index to apply in order to achieve a given policy result other than reducing rent increases.

It is in jurisdictions which seek to index NOI by use of partial index readings where meaningful technical commentary is possible, so this discussion will be narrowed to jurisdictions of this type.

The above discussion makes clear that the most crucial of the threshold questions from the standpoint of use of all or only a portion of the change in a general price index is whether such a jurisdiction feels that some portion of the flow of rent receipts to landlords should not be indexed for the full effects of general price inflation. As we have seen, the usual explicitly named candidate for this exclusion is the portion of the receipts used to pay debt service. The clearest exposition of

the rationale for such exclusion is found in a recent memorandum to the Santa Monica Rent Control Board (SMRCB) from its staff, which states the following:

In the recent history of the general adjustment, NOI has always been adjusted on the basis of 40% of the CPI, except in years when the general adjustment itself was 66% of the CPI. This methodology was originally devised with the assumption that 60% of the NOI in 1978 went to debt service and 40% went to cash flow. It was assumed that debt service should not change from year to year, and that cash flow should increase at the rate of the CPI. The formula was designed to accomplish this.¹

Several characteristics of this rationale are worthy of note. First, it is based on assumption rather than empirical evidence of what share of receipts were actually required to pay debt service in Santa Monica in 1978. Second, it assumes that no change in that ratio had occurred in the 12 years between that base year and the date of the memorandum. Third, it assumes no change in the owner's equity in the property over that 12-year period, without the necessity of the owner's receiving any return on the debt-financed portion of his/her investment. Fourth, it takes no account of the growth and eventual dominance of the use of variable-rate mortgages which sensitize debt service to inflation. Finally, it assumes that indexing the non-debt service component of NOI at only 40% of the rate of inflation will in fact permit the purchasing power of that component to keep pace with inflation.

¹See June 18, 1990 memorandum from Staff to Santa Monica Rent Control Board regarding, Supplemental Staff Report - annual General Adjustment 1990/91 -- NOI Component, p. 1.

While all of these assumptions are questionable, the final one is necessarily incorrect as a matter of mathematics. Indeed, this fact has been recognized by SCRCB staff. Another memorandum from that source observes the following:

Over the years, however, a problem has arisen from this approach. In 1978, Net Operating Income represented 65% of the rent dollar. Over the eleven years of general adjustments, this portion of the rent dollar has shrunk to 55.29%. The reason is that the NOI has been permitted to increase at 40% of the CPI while nearly all of the other components of the rent dollar have increased at a higher rate, most of them between 66% and 100% of the CPI, some at a much higher rate. The current methodology inevitably causes the NOI to shrink as a component of the rent dollar.¹

Not only is the final observation true, but no other direction of change is mathematically possible. If operating costs are indexed at the full inflation rate and NOI is indexed at only 40% of that rate, NOI must shrink in relative terms. If it is in fact true, as assumed, that the portion of NOI which the landlord must use to pay debt service cannot either grow or shrink, then it must occupy an increasing share of this shrinking NOI. If, as many others assume, debt service has grown on a non-trivial number of properties bought in the last eight years or so when variable-rate mortgages have come into vogue, then debt service has become an even larger share of shrinking NOI.

The basic result is not different in kind if the property is owned free and clear. In that case, the erosion of the real value of NOI is expressed in a direct reduction in the return the owner realizes on the property, and this reduction will be capitalized annually into declining real property values. In the case of properties that are financed by their owners, declining real NOI reduces the ability of the property to service debt which also is translated into declining real property values.

¹See May 31, 1990 memorandum from Staff to Santa Monica Rent Control Board regarding, Annual General Adjustment 1990/91, p. 8.

Put simply, it is a mathematical certainty, not an assertion, that any system which provides for full adjustment to inflationary changes in operating costs and only partial indexing of landlord NOI to general price inflation will, unless operating costs pursue a sustained course opposite to general price trends in the economy, result in erosion of the real value of NOI.

As noted above, Berkeley has placed great store in a second and somewhat different argument for applying only a percentage of the price index change to index landlord NOI for inflation.¹ This argument is based on the observed relationship between changes in national inflation rates and national rent levels. It asserts that changes in rents have historically lagged behind general price inflation, so that indexing NOI at less than 100% of the CPI is fair because it is representative of the operation of an unregulated rental housing market.

This case was developed by Berkeley's then attorney-consultant in his 1985 memorandum to BRSB regarding the indexing of NOI.² The core of the argument is that NOI has increased at between 32% and 50% of the inflation rate. The lower of the two figures is based on an analysis of changes in the national CPI and the rent component of the national CPI from 1913 to 1982, while the higher figure is based on the changes in the same relationship from 1970 to 1982.

¹Again, Berkeley differs from all other localities examined that use general price indices in excluding this form of indexing from AGA process. This part of the discussion refers to Berkeley's practice when it does permit use of the index, which is in the IRA part of its regulation process.

²See memorandum from Kenneth Baar, Consultant to Berkeley Rent Stabilization Board, regarding Regulation - "Indexing of Net Operating Income", dated March 15, 1985 (as revised May 13, 1985, pursuant to Individual Rent Adjustment Committee requests).

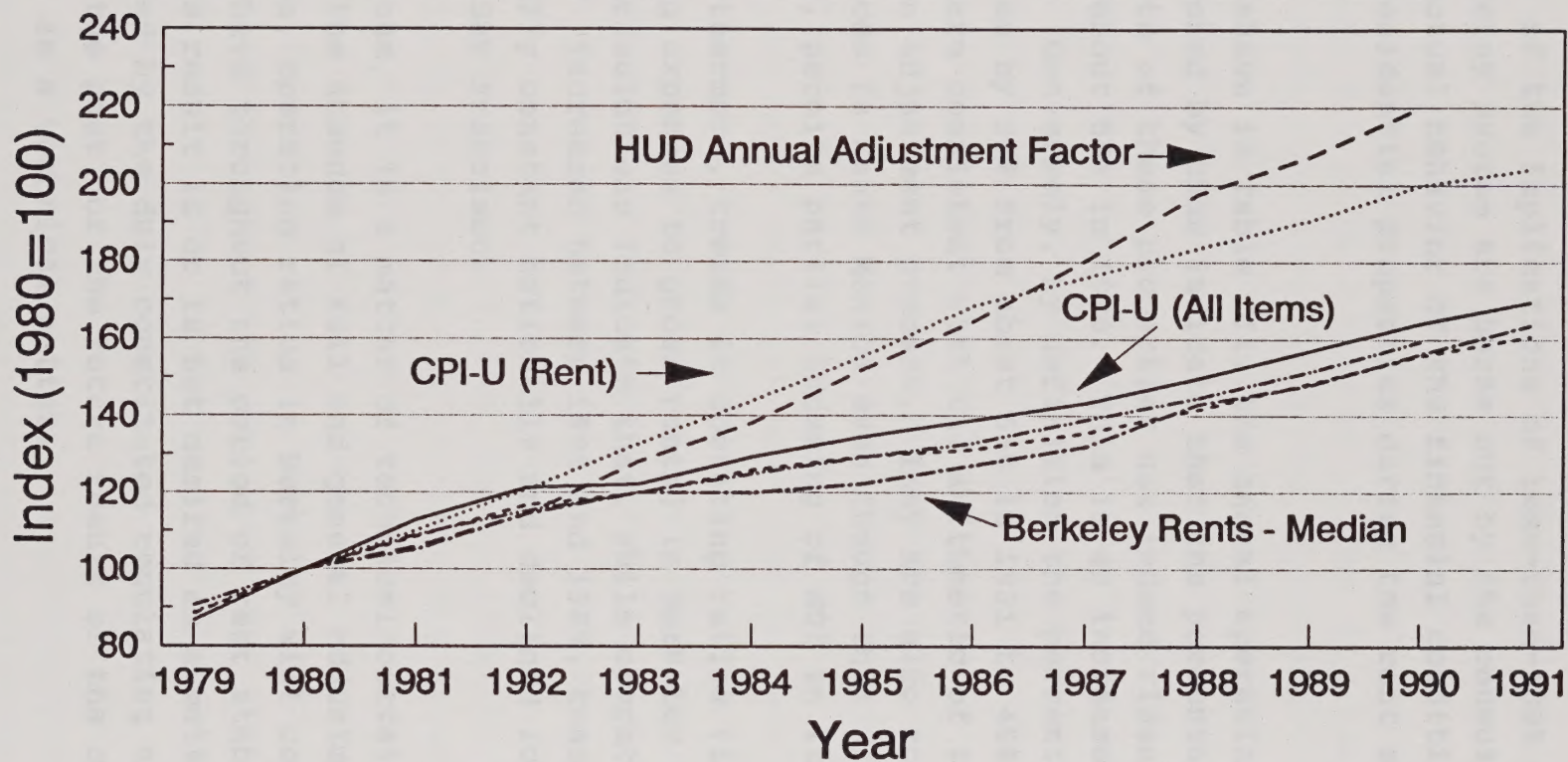
Numerous technical criticisms may be reasonably and, in the consultants' view, validly made of this argument. To economize on the reader's time, however, it may suffice simply to establish that to the extent that it has any merit, this approach generates precisely the reverse conclusion if it is carried out using more recent long-term data on the NOI-CPI relationship in the San Francisco-Oakland-San Jose CMSA.¹ These data are, of course, far more relevant than national price data to the situation in Berkeley.

The reversal is shown in Figure III on the following page. The Figure traces the fact that between 1979 and 1991, the rent component of the regional CPI-U increased more rapidly, not less rapidly than did the overall index. In percentage terms, rents in the region increased by about 130% from 1979 to 1991, while the CPI-U increased by about 96%. The method relied upon by the Berkeley attorney-consultant, if valid, would suggest that the City should have been indexing landlord NOI at more than 100% of inflation if its policy objective was to cause rents in its stabilization regime to bear the same temporal relation to general price inflation as non-stabilized rents.² It must therefore be observed from a technical perspective that, at the very least, this argument yields no sound basis for reducing the percentage of the change in the CPI-U used to index Berkeley NOI below 100%.

¹For an exhaustive critique of Baar's 1985 memorandum, see St. John and Associates, The Indexing Of Net Operating Income, November 1989.

²This leaves aside the fact that a substantial proportion of the rent component of the regional CPI-U is controlled or stabilized itself, thereby probably depressing the overall averages. To the extent this is true, even indexing Berkeley NOI to the relation between the rent component of the CPI-U and the overall index probably understates the relation between unregulated rents in the region and the behavior of general price levels there.

Figure III
SELECTED PRICE INDICES
San Francisco-Oakland-San Jose CMSA: 1979-1991



CPI-U (All Items)	CPI-U (Less Shelter)	CPI-U (Rent)
_____	-----	
HUD AAFs	Implicit Price Deflator (PCE)	Berkeley Rents - Median
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D. Actual Behavior of Berkeley Landlords' NOI

All of the implications of less-than-100% indexing of NOI in the Berkeley system are borne out by the consultants' examination of the actual behavior of the financial condition of Berkeley rental residential properties during the rent stabilization period.

As shown in Table III, the annual operating cost studies commissioned by BRSB indicate that the percentage share of operating costs of these properties has indeed risen from about 44% in 1981 to about 55% in 1990. This is an increase of about one-quarter. Conversely, by definition the percentage share of NOI has fallen by 32% from about 66% in 1981 to 45% in 1990. These changes are consistent with the arithmetic of the Berkeley inflation adjustment process. They are also consistent with the experiences in Santa Monica even though that City, unlike Berkeley, permits partial indexing of NOI in its AGA process.

Furthermore, trends in operating ratios (i.e., the ratio of operating expenses to gross rents) in Berkeley compared with other jurisdictions indicate that, while operating ratios in Berkeley increased between 1981 and 1989, these ratios remained essentially constant nationally and declined for rental properties in San Francisco.

In sum, it is a matter of technical certainty, not opinion, that in the absence of full and general adjustment of NOI for inflation, operating ratios in Berkeley will continue to increase as they have throughout the period of rent stabilization. Whether this result is or is not desired as a matter of policy must be decided by the duly constituted regulating authority. But neither the past nor the future result of the current policy is in doubt as a technical matter.

5. Choice of Base Year

The choice of the base year is always significant in rent regulation regimes, but it is especially crucial in a system like Berkeley's which does not permit vacancy decontrol or any other device by which rents are permitted to be adjusted to unregulated market levels. In this kind of system, the base year becomes the point of reference upon which the fairness and other major characteristics of the system depend regardless of how many years or decades the regulation regime may continue in force.

Because the adoption of rent regulation usually occurs in the context of a perceived failure or disruption in the local rental housing market which is deemed severe enough to justify government intervention, market conditions in the year in which adoption occurs tend to have some characteristics which make them arguably atypical of the normal workings of the unregulated rental market. Moreover, the great diversity of individual situations in any urban center at any point in time guarantees that some non-trivial share of landlords and tenants will be in some set of special circumstances in any given year. These conditions will differ from the majority of other landlords and tenants. Indeed, they may differ from the conditions which obtained among these same landlords and tenants in other years. Because it is usually considered infeasible for the adopting local government to ferret out in advance all of these individualized complexities affecting a minority of local landlords and tenants, they are not usually known to or contemplated by the adopting authority in the law or ordinance it adopts. As the existence of these special circumstances emerges in the course of administration of the regulatory regime, the base year tends to become more and more controversial as time wears on.

For these and other reasons, vigorous argument as to the appropriateness of the base year selected tends to be a perennial feature of rent regulation systems, particularly those which

permit no point of adjustment to market rates. Simple resolution of the issue is usually precluded because any alternative base year will bring to light its own array of specialized circumstances and problems.

Typically, rent regulation ordinances roll rents back to a date about three to six months prior to the adoption of controls. The primary rationale offered for this rollback is that it revokes rent increases that may have been imposed by landlords in immediate anticipation of controls, while also making the point of regulatory reference predate the period of severest market disruption which led the local government to intervene. In technical terms, such a short rollback seeks to set the base year reference point closer to a period of pre-crisis "baseline" market conditions, but still close enough to the conditions at the time of adoption to keep the regulatory reference point sensitive to long-term trends in the market at the time of adoption.

The hope is that this short rollback will result in a balance between landlord and tenant interests which both parties will consider fairer than the crisis conditions prevalent at the time of adoption. From the tenants' perspective, the rollback eliminates any very recent wave of rent increases. From the landlords' point of view, the briefness of the rollback period maximizes the likelihood that recent increases in operating expenses will be preserved in the base period. Thus, the base period represents a balance between the competing objectives of rent control regulations, which attempt to protect renters from unduly volatile and burdensome rents while allowing landlords to maintain the economic viability of their rental properties.

In Berkeley, the year of adoption and the stated base year for landlord NOI is 1979, but indexing has until recently begun with June 1980. In the Searle decision, the Court noted that "[t]he Board has proffered no rational basis, nor can one be

imagined, for indexing from June 1980 in order to maintain the net operating income of base year 1979."¹ In response to this ruling, BRSB amended its Regulation 1264 to allow for indexing from June 1, 1979, and thus made the base year for indexing consistent with the stated objective of maintaining NOI for 1979. This appears to the lay consultants to have eliminated the particular aspect of prior Berkeley indexing/base year policy for which the Court found no rational basis.

However, it must be further observed, from a technical standpoint, that this change will not result in a base year for either NOI or indexing which can be argued to represent baseline market conditions prior to the advent of regulation. Rent regulation actually began in Berkeley in June 1978 when Measure I was adopted by the electorate and immediately froze rents at their then current levels. Since all subsequent rent increases and decreases were based on changes in operating costs after that date, NOI was effectively frozen at that time. Rents had been frozen for a full year by the time that Measure D installed the initial form of the Berkeley Rent Stabilization Ordinance in June 1979. That Measure did not follow the more usual practice of rolling back the base period to an interval a bit prior to the point of initial public action in June 1978. Instead, it established as a base year a period subsequent to that action during which rents, but not operating expenses, had been frozen. Whatever other merits may be cited for this action, it cannot be argued to have created a base year which mirrored baseline conditions in the unregulated market.

If, therefore, the Board or a reviewing court takes the view that the base year which sets the relationship between NOI and operating expenses should attempt to strike the balance between landlord and tenant interests that is discussed above, it seems clear that the 1979 base year does not achieve this in Berkeley.

¹Searle opinion, at p. 14.

A base period which met this standard would need to precede the freezing of rents in June 1978, and perhaps precede it by some time in order to remove from the base the anticipatory actions which may have accompanied a highly publicized initiative campaign. There is apparently no existing data base from which one can predict with certainty whether this change in the base year would produce a net gain for landlord or tenant interests if the subsequent history of regulatory policies and effects were adjusted to this new base period. But there is a strong technical argument that, if the goal of establishing the base year was to start from something close to normal pre-regulation market circumstances, the 1979 base year does not achieve that goal.

Having said this, one must also recognize the complexity and overhead cost involved in any attempt at this juncture, well over a decade later, to recreate not only the universe of rents but also the associated universe of landlord costs in the Berkeley of 1978 or earlier. Many properties have changed ownership. Many, perhaps most, of the requisite records no longer exist or would be impossible to locate. The period was not only one of unprecedented peacetime inflation, but also of great tumult in the housing market and of hot debate and eventual voter approval of a change in the State's approach to property and general taxation -- Proposition 13 -- which revolutionized all prior practice. These conditions do not lend themselves to accurate recreation from the distant vantage point of the 1990s. Nor, it must be said, do they easily fit the ideal description of a pre-crisis base year.

Should the Berkeley regulatory authorities elect to attempt to replace 1979 with an earlier base year, therefore, the consultants must make two observations, speaking as technicians with considerable experience in assignments of this kind. First, the attempt would be an expensive enterprise because of the difficulty of assembling statistically valid samples of the requisite data. Second, in light of the data problems which would still

remain, together with the many unusual forces at work in the economy and in California property-related politics during the period, it would be unlikely that the result of the attempt would eliminate, or perhaps even substantially reduce, the controversy surrounding the issue of appropriate base year.

These observations lead to a related one which transcends the immediate question. Irrespective of whether the technically preferable base year at the time of rent regulation adoption in Berkeley was 1979 or some other year, it is invariably true in these matters that the more time that elapses after any base year in a Berkeley-type regulatory regime, the more problems arise because of that sheer distance in time.¹ Any single interval, if suspended as in amber and used as the basis for adjusting all subsequent relationships between interacting parties in one of the most frequent and basic human transactions, will eventually lose its relevance because of changing conditions in the society and the economy. It is legitimate to ask, therefore, whether the regulators' purposes are best served by even the most painstakingly accurate recreation of the conditions that obtained a dozen or more years ago. Even if this is the best approach now, the question remains whether the regulatory system can reasonably expect to use a fixed and increasingly distant period as its touchstone in perpetuity. These considerations should also be taken into account, in the consultants' opinion, as the Berkeley authorities ponder the issue of base year.

¹"Berkeley-type" refers to the type of regime which has no point at which rents are permitted to adjust to market levels. If this adjustment is permitted, the problem discussed here is usually much less severe.

6. Treatment of Debt Service

The Searle Court noted in a footnote to its decision¹ that the plaintiff landlord had requested a rent increase to cover increased debt service costs in the trial court proceedings, but had not pressed this issue on appeal. Since the issue was not placed before it, the Court of Appeal did not consider it, but did pointedly observe that, "...the Board still does not consider debt service in fixing NOI or in determining a landlord's fair return on investment."² Given the Court's interest, and the obvious consequences of any increase in debt service costs on the landlord's financial return from the property, the consultants were asked to address the issue of appropriate treatment of debt service in the course of indexing for inflation. This assignment included both the the technical merits of such indexing and the procedural question of how best to accomplish it if a policy decision were made to do so.³

This issue tends to cause confusion because debt service is an item of cost to the landlord, but it is usually discussed in the context of defining landlord net operating income. No one disputes that debt service is just as real a cost to the owner of a debt-financed property as any other cost that landlord must pay. But it is not an operating cost and until fairly recently it was not a cost which varied over the life of the mortgage.

The fact that debt service is not an operating cost has been taken by some localities to imply the principle that it should not be taken into account in a regulatory regime focused on the net operating income of the landlord. The fact that debt service

¹Searle, at p. 3.

²Ibid.

³The relationship of changes in debt service costs to the landlord's rate of return on investment will be discussed in the subsequent report addressed to the issue of fair rate of return.

has traditionally been a fixed cost over the life of the mortgage has sometimes generated the principle that the portion of gross landlord income which is required to pay this cost should not be indexed for inflation because this cost is immune to inflationary impact.

As we have seen in the comparative analysis, the policy reflection of these principles in the inflation indexing localities which have embraced them has come in the form of two practices:

- * If they undertake to define NOI, such localities normally ignore debt service costs in the calculation.¹

- * Whether or not they define NOI, such localities often use a partial index reading to adjust either rents or NOI for inflation, with the fraction explicitly or implicitly intended to avoid indexing the proportion of landlord gross income which is used to pay debt service.

We have seen that this approach is not followed by the majority of the rent stabilization regimes in the comparative analysis. The majority of these regimes either do not index for inflation at all or use a full index reading to make inflationary adjustments (though in some cases they also apply floors and ceilings on the effect that such an adjustment can have in any one year). Nevertheless, the above principles have been accepted and applied in a number of jurisdictions, including Berkeley.

A regulating locality's policy decision as to how to treat debt service from an inflation indexing standpoint involves two threshold questions. First, should the regulatory regime take

¹This is also standard practice in operating income/cost calculations performed in the real estate industry.

debt service into account at all as a separable element of the landlord's income stream? Second, if so, how should this element be identified or approximated for regulatory purposes?

With respect to the first question, the basic case for separate treatment of indexing of income used to pay debt service is that this cost is assumed to be fixed, and that landlord profit should not be permitted to rise by treating it as though it expanded with inflation. The fundamental opposing case is that financing techniques and terms comprise one of the backdrop factors taken into account by the landlord in making his/her investment decision which conditioned that decision and included some reasonable expectation of profit enhancement as a result of the interaction (or lack of it) between price inflation and the rents which can be charged. The regulatory regime, says this case, should not skew the variables in this decision by attempting to single out the portion of landlord income used to pay debt service, especially since very few regulatory regimes have been willing to incur the overhead costs necessary to determine the actual financing costs borne by each individual landlord during any given year.

If, notwithstanding the countercase, a locality answers the first threshold question in the affirmative, the second question emerges. It has always raised some complexities because landlords have always differed among themselves in both the balance between equity and debt that characterize their holdings and in the forms and terms of financing which they are able to obtain in financial markets. Until relatively recently these complexities have been tempered by the fact that once this balance had been fixed in the case of a given property, the chances were good that it would stay fixed over the life of the mortgage or until ownership changed hands, whichever came first.¹ But many of the same

¹This is not to deny that refinancings could occur and cause variations in the initial terms.

economic and market pressures which fueled the movement for rent regulation in Berkeley and many other localities also pressed financial markets to develop new financing instruments, chiefly the variable-rate mortgage, which sensitized monthly debt service costs to changes in surrounding economic conditions -- mainly to prevailing long-term interest rates. This evolution of financing instruments was especially early and prevalent in California.

During the period of hyperinflation at the end of the 1970s and beginning of the 1980s, the result was that conventional fixed-rate mortgages became less and less dominant in the financing of owner-occupied and rented residential properties, giving way to variable-rate mortgages. And both forms of mortgage were frequently supplemented by various forms of "creative financing" necessitated by the increasingly tight lending standards imposed by conventional lenders. In many cases, this financing required the seller to take back a significant part of the sales price as non-amortized debt with a short maturity (e.g., three to ten years) and complex provisions that allowed the interest rate charged to vary with changes in economic conditions. The total package of financial instruments involved in a given financing during this period, and to a declining extent in the years that followed, was often both much more complex and much more variable in its payment arrangements over time than had previously been the case.

Although rent regulating authorities were certainly generally aware of these developments, even those which undertook to account separately for debt service in their indexing regimes did not usually change their method of taking debt service into account in their indexing processes. Though regulators rarely issued formal explanations, it seems reasonable to presume that there were three main reasons for this. First, virtually none of these jurisdictions had based their treatment of debt service (i.e., the fraction by which they reduced the price index reading they used to index rents or landlord NOI) on detailed financing

cost information regularly requested of all landlords or secured through a regular, statistically valid sample of landlords. Therefore, although the general change in the financing environment was known, the degree of actual impact on the financing cost structures of local regulated properties was unknown and could not be learned or updated without imposing extensive new information requests and/or sampling procedures which involved substantial additional overhead costs.

Second, there was doubtless concern that making indexing sensitive to varying financing costs might create an incentive to refinance some unknown volume of properties, thereby worsening the instability in an already destabilized rental property market. Finally, it may have been felt that, since the flat percentage used to determine the partial index reading already failed to differentiate between differing landlord situations (e.g., the situation of the debt-free owner and that of the owner with a large mortgage), it was neither more nor less fair that this differentiation continue as the financing environment became more complex.

Whether for these reasons or others, localities which attempted to take separate account of debt service in their rent regulation usually did not, in fact, change their partial index readings in response to the increased incidence of variability in debt service costs. Their response to the second threshold question continued to be that the share of landlord rental income or NOI required to pay debt service costs would continue to be approximated through use of a single fractional reduction of the price index reading designed to reflect some general concept of the average ratio that these costs were assumed to bear to the total landlord income flow being indexed.

The fact of this absence of change in indexing policy does not, of course, determine whether this is the proper policy approach. That must be decided by the duly constituted regula-

tory authorities operating under the eye of reviewing courts. What remains in the consultants' assignment on this question is to review how the issue has been handled in Berkeley, and the technical merits of handling it in the future through the AGA and IRA procedures, respectively.

A. Accounting For Debt Service Costs in Berkeley

Berkeley does not currently permit the pass through to tenants of increased debt service costs in the form of rent increases except under highly restricted circumstances. Regulation 1276 limits rent increases for debt service to two special cases. The first applies to properties purchased or refinanced between June 6, 1978 and June 3, 1980 where the owner can demonstrate that rents were not increased prior to the adoption of the Ordinance to cover any such cost increases.¹ The second case is comprised of properties that were refinanced after June 3, 1980 as a result of a financing agreement made prior to the adoption of the Ordinance.² The actual rent increases permitted in both of these two types of case are subject to additional conditions that specify allowable debt-to-equity ratios, loan terms and interest rates.

The avowed purpose of Berkeley Regulation 1276 in barring most pass throughs of debt services costs in all but these exceptional circumstances, like the goal of the similar limitations adopted by other jurisdictions, is to prevent "speculative increases" in rents that are based on property values which are artificially inflated by investors seeking to manipulate the market and to benefit from the volatility they cause. Absent such a bar, and assuming that rent controls hold rent levels below market level, the potential to raise rents to market level upon sale or refinancing of the property, by means of an adjustment

¹See Regulation 1276 A.

²See Regulation 1276 B.

for increased debt service, will be at least partially capitalized into property values.¹ Thus any allowance for rent increases to meet increased debt service costs upon sale or refinancing of regulated properties is often seen to permit unacceptable circumvention of the public policy purpose of rent regulation by failing to discourage speculation.²

However, the line between speculation and investor attempts to cope with exogenously caused market volatility is sometimes hard to draw, particularly when economic conditions are in the unusual state of flux in which they found themselves in the years just before and for some time after the adoption of rent regulation in Berkeley. This difficulty is reflected in the two different perspectives on fairness which are characteristic of landlords and tenants, respectively, when debating this question.

From the landlords' standpoint, increases in costs, whether debt or operations related, lower the amount of cash otherwise available to pay those costs. In the absence of a rent increase to cover any increase in debt service costs, the landlord is unambiguously worse off for reasons that are arguably dictated by

¹The extent to which the opportunity to set market level rents is capitalized into property values is limited by the perceived risk of the investment opportunity. If potential buyers believe that the probability of using the petition process to get rent adjustments to market levels is very high, then most of the rent increment will be capitalized into property values. Conversely, if the outcome of a petition for a rent adjustment to meet increased debt service is believed to be highly uncertain, the potential for rent capitalization will be diminished. Uncertainty about what constitutes a market rent in a regulated market may also diminish the potential for rent capitalization.

²This problem is a variant on the so called "circularity" problem inherent in "fair rate of return" standards which base their calculations on the landlord's return on the value of the property. Since the probable capacity to increase rents upon sale or refinancing is capitalized into higher property values, the rate of return on value after the rent increase has been capitalized into a higher property value is likely to be below the minimum rate of return established by such a system as "fair."

financial market conditions over which he/she has no control. This is asserted to be unacceptable in a regulatory regime that is supposed to allow for the rent increases necessary to preserve the landlord's base-year financial condition, and which relies on this to maintain landlord incentive to invest and reinvest in the local rental housing stock.¹

From the tenants' perspective, on the other hand, increases in debt service costs attributable to variable-rate mortgages or creative financing are arguably foreseeable by the landlord at the time of purchase, and, as such, represent the consequences of a fully informed investment decision. Moreover, at least at present, landlords can, depending on their investment and risk preferences, choose between fixed-rate and variable-rate financing for rental properties. And, at all times landlords have the option of not investing in rental property at all. Thus, rent adjustments to account for increased debt service costs are argued to be unfair on the ground that they penalize tenants for any negative effect upon landlords because of what turn out to be poor investment decisions.

These opposing fairness arguments are not mere flights of rhetoric. They can translate into real world differentials which many may consider unfair. If debt service variations are not passed through in rents, one can have two identical buildings with identical rent rolls yielding a quite different level and steadiness of return to landlords who are identically situated from a financial standpoint except that one was in a position to invest during the era of the fixed-rate mortgage monopoly, while the other came into that position in the variable-rate mortgage

¹It should be noted that in an unregulated system, the landlord's actual flexibility to charge and receive a rent differential reflecting a change in his/her debt service obligation would depend upon how many such landlords were present in the market attempting to make the same sort of change. If such landlords represented a small minority, tenants might successfully avoid their buildings in favor of lower rents for the same quality of accommodations elsewhere in the market.

era. Conversely, if debt service variations are passed through, it becomes possible to have two tenants in identical buildings and financial situations paying different and more volatile rent levels for the same accommodations solely because of the way the purchase of each building has been financed or refinanced.

Furthermore, each situation can be argued to continue in perpetuity. If the regulation system never permits increases in debt service costs to be reflected in rent increases, this fact is mirrored in lower sale value than would otherwise be the case, thereby both penalizing the landlord who is forced by the market to take a variable-rate mortgage and depressing the incentive for both that landlord and his/her successor owner to reinvest in the upkeep of the property. On the other hand, if the system does permit pass through, this positive differential is capitalized into property value and the rent differential between tenants in physically identical buildings is perpetuated.

Any veteran of the rent regulation policy debate can make a strong case for either side of this argument, and many such veterans have done so in Berkeley. Like most tough issues of social policy, there is no clearcut, technical, uncontroversial answer. What can be said with confidence is that the answer that seems to have been adopted to date in Berkeley asserts the following:

- * Except in two very specialized circumstances specifically addressed in BRSB Regulations, neither debt service costs nor any variation therein should be taken into consideration in any way in the inflation indexing process.¹

¹The Searle Court noted that the City had presented two arguments for its use of a partial price index reading for inflation indexing purposes, one based on an asserted lag between landlord NOI behavior and the behavior of the national CPI which was discussed in an earlier section of this report, and the other on the reported fact that the figure of 40% of the CPI-U was the result of a negotiated settlement between advocates of higher and lower percentages. Neither of these arguments apparently directly incorporated the debt service issue. This leads the consultants

* Debt services costs and variations in them should have no place in inflation indexing irrespective of whether such indexing is done in the AGA or the IRA process.

* Therefore, no information on the actual extent of or variation in debt service costs need be or has been collected from landlords or their financiers.

Consequently, from a technical standpoint any change in this policy which seeks to make Berkeley rent regulation sensitive to debt service costs or variations in them would require a wholly new process of cost information collection and analysis.

The latter finding reflects not only review by the consultants of the information now routinely collected from Berkeley landlords, but also a concerted but unsuccessful effort to find a local, regional, State, Federal or private data source from which such information might be drawn without a laborious process of new collection. Though this effort did produce sources of data on transfers and sale prices of Berkeley rental properties, it did not yield any source of information on the financing techniques or terms involved. It is now clear that no accurate source exists except the landlords and/or the private institutions and individuals from whom they obtain financing.

B. Indexing Debt Service Through an IRA or AGA Process

Assuming a decision had been made to allow rent adjustments to reflect changes in debt service costs, this might be done through either the annual general adjustment (AGA) process or through the individual rent adjustment (IRA) process.

to the conclusion that the BRSB position to date has been that debt service costs are simply irrelevant to rent regulation (except in the two exceptional situations provided for in Regulation 1276), as against any position to the effect that debt service costs represent 60% of landlord NOI.

The AGA process involves the calculation of a rent adjustment that is generally applicable to all regulated properties. As such, it seeks to apply to cost items which are reasonably common to all such properties and whose behavior can reasonably be assumed to be roughly similar with respect to most properties. Often, as we have seen in the comparative analysis, AGA's are promulgated in the form of an allowed percentage increase in rents that is based on either specialized operating cost studies or general price indices, or both.

The use of the AGA process when the assumption of general applicability to the cost components of most properties is badly flawed will generate excessive rent increases for some property owners and insufficient increases for others. A good example is the operating cost impact of increased property taxes. Since the adoption of Proposition 13, the property tax rate is set at a constant 1% of assessed value, and assessed value is allowed to increase by no more than 2% per annum beyond its level in a stated base year so long as the property is not sold. Thus, for properties that have not been sold since the Proposition was passed in 1978, these factors provide a reliable and credible basis for estimating the increase in the property taxes for all rent-regulated properties in a given municipality. Given the general applicability of the initiative, derivation of a reliable and credible index of property tax increases is also possible. In fact, property tax increases for stabilized properties in Berkeley are estimated, as described above, as part of the AGA process, and adjustments for these increases are incorporated into the Berkeley AGAs.

On the other hand, a highly particularized cost increase incurred by a small number of properties is much better suited to handling through the IRA process. Take as an example the increase in the assessed value of property upon sale. Since the increase in assessed value only occurs to a relatively small number of properties in any given year and the size of the in-

crease will, on average, increase significantly with the length of ownership, there is no reliable or credible percentage increase that could be applied generally. Any given increase would be too large for the majority of properties that were not sold, and, if no deviation from the average property tax increase provided in the AGA were permitted, this increase would be too low to reflect the operating cost increases in those properties that were sold. Clearly, in this example, the calculation of increased property taxes upon sale is most sensibly performed in a highly specific IRA procedure that is initiated by the new owner. This owner will possess incontrovertible evidence of the required tax increase in the form of "before sale" and "after sale" property tax bills. In fact, therefore, Berkeley has adopted IRA regulation 1279 which allows for a short-form IRA process to adjust rents for property tax increases incurred upon sale of a rent stabilized property.

Debt service variations are likely to be much more like the second example than the first. The debt service situation of a rental housing property involves at least three material dimensions: (i) the existence and nature of the debt owed on the property (i.e., owned free-and-clear, fixed-rate mortgage, variable-rate mortgage, multiple mortgages and other debt instruments); (ii) the relationship of debt to equity investment; and (iii) the initial interest rate and any mechanisms that can be used to adjust this initial rate up or down.¹ Differences along any one of these dimensions can lead to wide variation in actual variations in debt service costs. The most obvious variation is related to differences in the nature of the debt. Properties that are owned free-and-clear and those financed with fixed-rate debt will not incur any increase in debt service costs, while

¹The following is a short list of cost-of-funds indices currently in use by financial institutions issuing variable rate mortgages: (i) Federal Home Loan Bank Cost-of-Funds (11th District and national index); (ii) six-month Treasury Bill rate; (iii) one-year Treasury Bill rate, adjusted to constant maturity; (iv) national contract rate on previously occupied homes.

those financed with variable rate mortgages may experience increases and decreases in debt service costs. But this most obvious difference far from exhausts the range of similarly large differences in experience which can reflect differences along one of the other dimensions.

The possible incidence of such differences among properties is only hinted at by the sparse data available that arguably provide some indication. It has already been noted that data on the debt characteristics of rental properties are not readily available. But there are some national figures on owner-occupied housing which may be informative. American Housing Survey data indicate that approximately 43% of all owner-occupied homes are owned free and clear, and that, of the remaining 67% with some form of debt, 77% are financed with fixed-rate mortgages.¹ If the financing characteristics of rental properties in Berkeley are even remotely similar, it is difficult to imagine how a reliable index to reflect debt service variations suitable for use in an AGA process could be constructed. The additional complexities introduced by the variation in debt-to-equity ratios and the differing mechanisms used to adjust variable rate mortgages only reinforce this conclusion.

The consultants believe that it can safely be concluded on a purely technical basis, therefore, that any direct inflation indexing of debt service which undertakes to differentiate according to the particular situation of landlords can only be sensibly administered through an IRA process.

¹U.S. Bureau of the Census, Statistical Abstract of the United States: 1990, (110th edition.) Washington, D.C. 1990, Table 1278, p. 722.

7. The General Issue of Inflation Indexing Through an IGA or an IRA Process

The Searle decision requires BRSB to design a constitutionally defensible mechanism for adjusting NOI for the effects of inflation. As already noted, there were two main themes to the Court's objection to the current approach to NOI inflation adjustments which is found in Regulation 1264, namely (i) it requires property owners to go through a time consuming and costly IRA procedure to obtain an adjustment to reflect inflationary conditions which are presumably generally applicable to owners of rent stabilized properties; and (ii) there is no rational basis for the selection of 40% of the change in the CPI-U as a partial indexing factor. The issue of partial indexing has already been discussed. This section responds to the consultants' assignment to examine the technical merits of the use of only an IRA process for general indexing for inflation.

As pointed out in the above discussion of debt service indexing, the AGA rent adjustment procedure is an appropriate mechanism for making general rent adjustments that account for factors that are likely to affect all stabilized properties in similar ways and degrees. Furthermore, as indicated in the example of accounting for increased property taxes upon sale, the use of an AGA procedure for cost increases that are not generally applicable to all properties is likely to overcompensate some property owners and undercompensate other owners relative to actual cost increases. Thus, if the sole policy objective of the regulatory authority were to make the most precise and analytically defensible rent adjustment that is possible for each individual property, then a property-specific IRA procedure would, by definition, always be preferable to the more general AGA procedure.

However, the parallel objective of overhead cost-effectiveness has also been established, not just in Berkeley but in virtually all other rent regulating jurisdictions.¹ This objective calls for rationing of costly IRA procedures, substituting the much less costly AGA adjustment process to make adjustments where it can reasonably be maintained that the relatively small differential in impact on different property owners of the factors causing the adjustment is not worth the expenditure of tax- or fee-payer funds necessary to fine-tune the adjustment.

Note that once it has been established that any factor is to be treated through an AGA process, the nature of the question shifts. It can always be argued, as acknowledged above, that no factor should be so treated -- that all adjustments should result from individualized proceedings specific to each property. But once it has been conceded that some factors may be handled through an AGA process, and some factor has in fact been chosen for this treatment, the issue becomes whether another factor being considered for similar treatment is less suited to it than the factor already being approached in this way.

The consultants' reading of Searle is that it is in this respect that the Court found the Berkeley approach indefensible. Berkeley had established an AGA process as well as an IRA procedure, thereby acknowledging that some adjustments could and should be handled in the AGA manner. Berkeley had then decided to use the AGA process to adjust for average changes in the operating costs experience of landlords in the City, thereby establishing the principle that adjustments for general changes in prevailing costs would be handled on an across-the-board

¹The system employed to control the rents charged in the "old law" units in New York City is an arguable exception to this rule. That system was designed to trace the actual financial events and circumstances in every unit during every year, thereby generating an annual adjustment decision tailored to each unit. But this approach is notable for its departure from the approach taken by virtually all other rent regulating communities.

rather than a property-specific basis. The City had also decided to adjust rents for a stated fraction of the change in a general index of prevailing prices in the region. This would seem to have set the stage for use of the AGA process for these adjustments, using the same rationale already employed with respect to changes in prevailing operating costs.

However, alone among rent regulating bodies in California which index for general price inflation, Berkeley then refrained from handling adjustments for the impact of general price inflation on landlord NOI through the same across-the-board procedure. In arguing Searle, the City advanced three arguments in defense of this approach. The first asserted that landlords could receive reasonably prompt adjustments through individual petitions. The other two arguments were to the effect that the number of landlords who would be in a position to file a meritorious petition for an inflation-based adjustment would somehow be materially reduced by the fact that all landlords had already received an operating cost-based AGA adjustment. The Court found the first argument irrelevant because it begged the question of whether there was a rational basis for forcing landlords to file individually for an inflation adjustment -- however quickly they might be able to receive a response to such a petition. The other two arguments were rejected on grounds of implausibility and lack of supporting evidence.

Although the question has been examined anew by the consultants, HR&A has also found no technical basis for the distinction between the general process for handling adjustments for increases in landlord operating costs, on the one hand, and for a given percentage of the change in the general price index, on the other. None of the arguments advanced in the City's Searle argument have any technical merit that is discernible by the consultants. The only additional argument for the City's practice which has appeared in the interim asserts that the petition process is necessary in order for BRSB to play a role "much like

the court system" in policing and verifying landlord presentations of their actual operating costs, so as to similarly police and verify what they claim as NOI.¹

But this argument ignores the averaging principle inherent in the Berkeley approach to both changes in prevailing operating costs and changes in prevailing consumer prices. In both cases, the City has elected to permit a single percentage adjustment, representing the average experience of all property owners as a result of these cost and price changes, to be applied to the rents charged by all landlords who receive the adjustment. The fact that the actual operating cost experience of a given landlord may differ substantially from the Citywide average is not allowed to affect the scale of the permitted adjustment. Likewise, on the price inflation side, the scale of inflation adjustment in NOI does not vary according to the scale of landlord NOI; if the landlord can show that price inflation affected NOI, he/she is due the full 40% adjustment as the consultants read the Regulations and understand the Court to have read them. As a result, some landlords will do better and other landlords will do worse in both forms of cost and inflation indexing, depending upon how much their experience deviates from the average and by how much. This is the necessary effect of any AGA-type adjustment, and represents the inescapable price of using a more overhead cost-effective means of performing general adjustments over an entire population of affected parties, rather than bearing the overhead cost burden of individual, case-by-case determinations.

From a technical standpoint, it is difficult to imagine a defensible rationale which could permit adjustment of the component of the landlord's gross income stream that is used to pay operating costs according to the average inflation of those costs

¹See Memorandum from the Berkeley Community Law Center to BRSB member Marianne Lawless entitled "Rent Board Response to Searle", dated May 23, 1991, p. 12.

while denying a similar mode of adjustment for the average impact of inflation on the component of this stream which is used to pay income taxes and realize profit.¹ One could defend either use of the AGA process for both or use of the IRA process for both. There is no evident technical case, in the consultants' judgment, for using the AGA process for one and the IRA process for the other.

If these are the defensible options, which is the technically preferable? This depends upon the jurisdiction's sensitivity to overhead cost-effectiveness. Most jurisdictions which have chosen to index for inflation have decided that, in light of the considerable unit cost of IRA proceedings, AGA rent adjustments seem well suited for making rent adjustments to account for changes in general factors such as increased operating costs and general price inflation which are likely to affect all stabilized properties in roughly similar ways. Although a building-by-building IRA process should lead to more precisely accurate allowed rent adjustments, the average improvement in precision is likely to be small, especially when related to the increased cost of making such determinations. No technician is or should be in a position to determine how much incremental precision is worth how much incremental overhead cost to the authorities in the subject jurisdiction. Nevertheless, it is instructive that all localities examined herein which make such adjustments make them through an AGA process.

¹Note that this abstracts from the previously discussed question of the component of the stream that is used to pay debt service.

8. Conclusory Observations

The foregoing review of the issues the consultants were asked to address yields the following general observations:

- (a) All of the rent regulating jurisdictions compared herein which index for inflation either rely totally on a single regional price index or on a combination of such an index and a localized index of the behavior of landlord operating costs.
- (b) Berkeley is the only jurisdiction in California and among the full roster of jurisdictions compared which undertakes to index for inflation but does not do so through the AGA process.
- (c) Because of inconsistencies in analytic technique over time, it is impossible to say with confidence how accurately the annual cost studies commissioned by BRSB since the beginning of rent regulation in Berkeley have depicted actual changes in landlord costs.
- (d) The research found no index tracking regional or local prices which would be superior to the CPI-U for the San Francisco-Oakland-San Jose region as a basic price indexing instrument for use in Berkeley. The only remaining issue here is whether to use the CPI-U or that index minus its shelter component (called herein the CPI-U-S).
- (e) Rent regulating localities which index for inflation follow a variety of policies with respect to use of 100% vs. some fraction of the change in the CPI index, probably depending primarily on how these jurisdictions choose to treat the share of landlord income used to pay debt service. Some jurisdictions that employ 100% of the index reading

also place either a ceiling, or a floor, or both on the change in rent which can result from this indexing in any given year.

(f) It is a mathematical certainty that indexing of landlord operating costs at their full rate of inflation while indexing landlord NOI at a fraction of the rate of inflation will, over time, reduce the share of gross landlord income represented by NOI and erode the real value of NOI. The data available in Berkeley indicate that this has in fact occurred throughout the period of rent stabilization. If Berkeley policies remain unchanged, it is mathematically inevitable that this trend will continue.

(g) If Berkeley were to continue to rely on the technically questionable principle, which it advanced in Searle, that the index reading used to adjust for inflation should vary with the relation over time between changes in general consumer prices and changes in rents, consultant review of the recent (1979-91) behavior of this relationship in the region indicates that the annual adjustment would be running well over 100% of the change in the regional CPI-U, and would have been doing so, on average, throughout the period since the advent of rent stabilization in Berkeley.

(h) Even after the recent movement of the Berkeley base year from 1980 back to 1979, the base cannot be considered a period which meets the landlord-tenant interest balancing standard usually sought in a base year. However, further movement of the base year back in time would present difficult problems of statistical recreation.

(i) The explicit or implicit assumption that landlord debt service obligations are not sensitive to inflation impact, which underlies the decisions of some localities to use a partial index reading as an inflation adjustment, is clearly

incorrect with respect to some portion of properties, especially those financed from the late 1970s through the mid-1980s. The size of that portion is unknown, and no data source was found from which it can be estimated or the degree of cost impact can be measured. A major new data collection effort would be required to document the extent and intensity of this impact in Berkeley. If it were decided to permit changes in debt service obligations to be reflected in rent adjustments, such an adjustment process would be far better suited to an IRA than an AGA process.

(j) Although an IRA adjustment process should always yield a more precise, property-specific adjustment, reasonable concern for overhead cost-effectiveness has led almost all jurisdictions which index for inflation to use an AGA process for adjustments that are likely to affect the whole population of property owners in roughly similar ways. Indexing for both inflation in both operating costs and in consumer prices meet this description. A technical case can be made for doing both cost and general price indexing through AGAs or doing both through IRAs, but the consultants see no persuasive technical case for using a different process for each.

V. Minimum Changes Needed in BRSB Regulations to Comply with Searle

The final assignment to the consultants in the indexing phase of their work was to identify the basic changes which would need to be made in BRSB Regulations to comply with the Searle decision. As should be clear from the foregoing discussion, if the Board were to decide on new answers to one of more of the threshold questions posed in connection with each of the central policy choices, a wide variety of changes in existing Regulations would be required.¹ However, the assignment is taken to request identification of what the consultants consider the minimum general changes in Regulations which would need to be made even if Berkeley's responses to these threshold questions remained basically the same.

In that case, the changes required would not be very complicated. The Court identified three items which pertain to NOI indexing: (i) NOI indexing through the AGA or IRA process; (ii) the choice of full or partial use of the price index reading to adjust NOI for inflation; (iii) the choice of a base year. Each of these items is discussed in turn below with respect to changes in BRSB Regulations. The discussion proceeds from the most general decision the BRSB must make (indexing in IRA or AGA) to the least general decision (choice of base year).

All NOI indexing provisions are currently contained in BRSB IRA Regulation 1264, and all AGA adjustment provisions are contained in Regulation 1100. If the Board determines that the Searle ruling permits it to continue to perform price indexing through the IRA process, and that this process remains the proper

¹This is not meant to state or imply any view on the part of the consultants as to whether, and if so to what degree, BRSB has the legal authority to change the authoritative responses to any of these questions.

place for NOI indexing, then no change in the Regulations is required. However, the Board may wish to add language stating what it considers to be the rational basis for this decision. If on the other hand, the Board determines, and/or reads the Searle decision to require, that NOI indexing is more properly done through the AGA process, then the language found in Regulation 1264 must be moved from the IRA section of the Regulations to Regulation 1100, which covers AGA procedures.

Having determined whether NOI indexing is properly accomplished through an IRA process or an AGA process, the Board must next decide whether use of the full change or a fraction of the change in the price index is appropriate. The language regarding the extent of NOI indexing must be modified to reflect the Board's decision in the appropriate IRA or AGA section of the Regulations. Once again, a statement which describes the basis for the Board's decision may be appropriate. If the Board moves the NOI indexing provisions to the AGA section of the Regulations and opts to use the full change in the index, language may be needed to account for the potential conflict with Section 11 (4) of the Ordinance, which requires an affirmative vote of six, rather than the usual five, Board members if "a formula greater than forty-five percent (45%) of the CPI" is adopted.

Finally, the Board must choose a base year for the indexing calculations. If 1979 is selected, then no further changes are required because the Board has already taken action in response to this aspect of the Searle decision. However, if the Board determines that a base year other than 1979 is appropriate, then this language must be modified in either the AGA or the IRA sections of the Ordinance as appropriate.

VI. Consultants' Recommendations

The consultants have been asked by the Board to state their own recommendations with respect to the key issues raised by the Searle ruling. This section provides these recommendations in summary form. Careful note is taken where the consultants believe that a particular recommendation does not rest primarily on technical grounds, and/or is not required in order to comply with Searle. Still, it must be recognized and acknowledged that at this point this report passes beyond the zone of analysis into the sphere of subjective opinion. The prescriptive views of the consultants should be regarded as nothing more than another set of opinions which BRSB may wish to take into account in its deliberations.

The recommendations are also conditioned by two specific parameters established by the Board in making the assignment to the consultants. First, in the words of the then BRSB Executive Director, "we should be quite clear that there is no question at this stage of changing the rent law....Of course there is a sense in which the appellate decision invalidates certain provisions of the Ordinance....But [the Board's] "task is to enact regulations which are, to the extent possible, consonant with the Ordinance and with the appellate decision." [Emphasis in the original.]¹ The consultants' recommendations remain, to the best of their knowledge, within this stricture.

Second, these recommendations are based on research solely directed to the principles that are or could be applied to the issues raised by Searle, not based on quantitative or other empirical research of the specific consequences which their

¹Letter from Joseph F. Brooks, then BRSB Executive Director, to Edward K. Hamilton, President of HR&A, dated February 11, 1991, p.1.

application would have on the various sub-groups of Berkeley residents and property owners who would be affected. Quoting again from the then Executive Director's letter, "...we are not interested at this time in consequence analysis. We are interested in establishing principles....It is possible that the Board, at some future date, would seek to arrange for an analysis of the consequences of Berkeley's rent law, but that is not our intent at this time."¹ This position of the Board is quite understandable in light of the cost of the quantitative research and forecasting which empirical analysis of this kind would entail. Nevertheless, it must be understood that no such analysis has been commissioned or performed by the consultants.

Finally, it must be recognized that the consultants' view necessarily rests on the foundation of their interpretation of Searle, which has been stated at various points in the foregoing discussion. To the extent that the Board, having received the advice of legal counsel, arrives at any differing interpretation, the appropriateness of these recommendations may change.

1. Recommended Basic Principles for Adjustment to Searle

The consultants recommend that the Board proceed on the basis of two fundamental principles in crafting its response to the indexing aspects of the Searle decision:

* Maximum clarity and comprehensibility of the rules and procedures governing indexing. The whole point of the indexing technique is to adjust entire populations of parties for changes in general conditions which affect them all in generally similar ways. An index is useful for this purpose precisely because and to the degree that it is readily understood by all parties involved.

¹Ibid., page 2.

* As much simplicity of administration as is consistent with the indexing principles adopted. The primary advantage of adjustment by indexing, as against adjustment through individual case-by-case examination, is that indexing can offer major savings in the unit overhead cost of administering rent regulation. This advantage can only be realized if indexing is achieved as simply and cost-effectively as possible.

The recommendations made below attempt to adhere to these principles, while remaining within the parameters set by the Board in its assignment to the consultants.

The consultants read these parameters to rule out one option which would embody the above principles to a substantially greater degree than any approach modeled on current Berkeley regulatory practice. This option would be a shift to the indexing of rents for inflation, rather than continuing to break the landlord's gross rental income into the portion needed to pay operating costs and a remaining portion called NOI, and then adjusting each portion for inflation according to separate indices. This shift would bring both much greater comprehensibility and much simpler administration while probably not, in the consultants' subjective opinion, materially reducing the equitability of the regulatory regime.

2. Recommended Process for Indexing

The consultants recommend a shift from the IRA to the AGA process for all indexing for inflation of both landlord operating costs and landlord NOI.

3. Recommended Operating Cost Index

The consultants recommend that Berkeley institute a new technique for landlord cost indexing based on a survey of the actual operating costs and recent trends in those costs experienced by a statistically valid sample of Berkeley landlords. The results of this survey should be validated and, if necessary, adjusted through comparison with State Franchise Tax Board (FTB) data based on the income tax returns filed by owners of the properties in the sample. The survey should then be repeated at least every fifth year thereafter, and FTB data should be relied upon to update the cost index for inflation in each intervening year.

The survey should be so structured as to collect the information necessary to determine the percentage share of the gross rental receipts of the surveyed landlords which is required to pay operating costs, thereby also recording the share that remains as NOI.

Because the survey will require time to design and conduct, its results should be installed for the inflation adjustment to be made in 1992. Meanwhile, the adjustment scheduled to be made in 1991 should be based on one more iteration of the current operating cost analysis methodology.

4. Recommended General Price Index

Landlord NOI should be indexed using 100% of the annual change in the Consumer Price Index for urban consumers in the San Francisco-Oakland-San Jose region less the shelter component of that index (i.e., the refined CPI-U referred to herein as the CPI-U-S).

5. Recommended Method of Calculation of NOI

The calculation of landlord NOI should be a derivative of the information on operating costs and their relation to gross rental receipts which is collected in the operating cost survey. Once this ratio has been established, the formula for calculating the permitted overall rent adjustment to account for inflation should be as follows:

$$\begin{aligned} & (\% \text{ share which is operating costs} \times \% \text{ change in operating costs}) + \\ & (\% \text{ rent share which is NOI} \times \% \text{ change in inflation index}) = \\ & \% \text{ rent increase permitted to account for inflation} \end{aligned}$$

This formula would both account for operating cost increases and maintain the real purchasing power of NOI.

6. Recommended Amended Definition of NOI

The consultants recommend that Berkeley conform its definition of landlord net operating income to the definition in general use by including a deduction for vacancy and collection losses from scheduled rental receipts.¹

7. Recommended Base Year

The consultants recommend that the current amended base year of 1979 be maintained. In making this recommendation, the consultants note that as a purely technical matter an earlier base year would be superior as a microcosm of the market situation that existed before rent regulation or the imminent prospect of it affected market behavior in a major way. Nevertheless, in view of the difficulty and resulting costs entailed in accurate

¹Though this recommendation is made on technical grounds, it should be noted that nothing in the Searle decision indicates that this change would be necessary in order to comply with that ruling.

recreation of the situation that obtained prior to the first collection of data for rent regulation in 1979, the consultants do not recommend following the technically superior course in this case.

The consultants further observe in passing that the relevance of any base year in the 1970s necessarily erodes as time goes on. Berkeley rent regulation authorities may wish to consider devising a different base construct to replace this one as it fades into the distance. However, no such step would seem to be required in order to comply with the Searle ruling.



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